



CONSULTATIVE DRAFT

CORE PRINCIPLES FOR EFFECTIVE ISLAMIC DEPOSIT INSURANCE SYSTEMS (CPIDIS)

*Comments should be sent to the Secretary-General of the IADI
not later than 18 July 2019 at email Service.IADI@bis.org*

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ABOUT THE INTERNATIONAL ASSOCIATION OF DEPOSIT INSURERS (IADI)

The International Association of Deposit Insurers was formed in May 2002 to enhance the effectiveness of deposit insurance systems by promoting guidance and international cooperation. IADI conducts research and produces guidance for the benefit of those jurisdictions seeking to establish or improve a deposit insurance system. Members also share their knowledge and expertise through participation in international conferences and other forums. IADI currently represents 90 deposit insurers. IADI is a non-profit organisation constituted under the Swiss Law and is domiciled at the Bank for International Settlements in Basel, Switzerland.

For more information about the IADI, please visit **www.iadi.org**.

ABOUT THE ISLAMIC FINANCIAL SERVICES BOARD (IFSB)

The IFSB is an international standard-setting organisation which was officially inaugurated on 3 November 2002 and started operations on 10 March 2003. The organisation promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include the banking, capital markets and insurance sectors. The standards prepared by the IFSB follow a lengthy due process as outlined in its Guidelines and Procedures for the Preparation of Standards/Guidelines, which involves, among others, the issuance of exposure drafts, holding of workshops and where necessary, public hearings. The IFSB also conducts research and coordinates initiatives on industry-related issues, as well as organises roundtables, seminars and conferences for regulators and industry stakeholders. Towards this end, the IFSB works closely with relevant international, regional and national organisations, research/educational institutions and market players.

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ABBREVIATIONS

| | |
|----------|---|
| BCBS | Basel Committee on Banking Supervision |
| BCP | BCBS Core Principles for Effective Banking Supervision |
| CDIF | Conventional deposit insurance fund |
| CDIS | Conventional deposit insurance system |
| CPIDIS | Core Principles for Effective Islamic Deposit Insurance Systems |
| EC | Essential criteria |
| FSAP | Financial Sector Assessment Program |
| FSB | Financial Stability Board |
| IADI | International Association of Deposit Insurers |
| IAH | Investment account holder |
| IBW | Islamic banking window |
| IDB | Islamic Development Bank |
| IDIF | Islamic deposit insurance fund |
| IDIS | Islamic deposit insurance system |
| IRTI | Islamic Research and Training Institute |
| IFSB | Islamic Financial Services Board |
| IFSB CPs | IFSB Core Principles for Islamic Finance Regulation (Banking Segment) |
| IFSI | Islamic financial services industry |
| IMF | International Monetary Fund |
| JWG | Joint working group |
| KAs | Key Attributes of Effective Resolution Regimes for Financial Institutions |
| OECD | Organisation for Economic Co-operation and Development |
| ROSC | Reports on the Observance of Standards and Codes |
| RSAs | Regulatory and supervisory authorities |
| SCDIS | Shari'ah-compliant deposit insurance scheme |
| SLOLR | Shari'ah-compliant lender of last resort |
| SRR | Special resolution regime |

SECTION 1: INTRODUCTION

1.1 Background: The Need for CPIDIS

1. The Islamic financial services industry (IFSI), with its proposition of inclusiveness, has progressed rapidly across the globe, embracing not just Muslim-majority economies but also other emerging markets and advanced economies. The development of this industry encompasses an increase in the business volume and number of institutions offering Islamic financial services, an enhanced variety of the products and services offered, improved legal and regulatory infrastructure, and new initiatives for international cooperation. Accordingly, the IFSI has gained significant market share and now constitutes an important building block of the financial system in many jurisdictions. This development and growth has raised a number of challenges for the resilience and stability of financial systems and for the protection of their users.

2. The critical role of financial safety-nets in the IFSI was stressed by the Islamic Financial Services Board (IFSB) in April 2010 when, in partnership with the Islamic Research and Training Institute (IRTI) and the Islamic Development Bank (IDB), a report was released entitled *Islamic Finance and Global Financial Stability*. The report identified eight building blocks aimed at further strengthening the Islamic financial infrastructure at the national and international levels in order to promote a resilient and efficient Islamic financial system. The third building block relates to strengthening of the financial safety-net comprising a Sharī'ah-compliant lender-of-last-resort (SLOLR) facility as well as a Sharī'ah-compliant deposit insurance scheme (SCDIS). Together with prudential supervision, SLOLR and SCDIS mechanisms form key components of the financial safety-net arrangements for sustaining financial stability, especially when confronted with a financial shock. The rules and principles that govern the IFSI mandate that the necessary provisions of financial safety-nets for institutions offering Islamic financial services must be Sharī'ah-compliant.

3. Financial safety-nets also represent a key component of preconditions for effective banking supervision, as identified in IFSB-17: *Core Principles for Islamic Finance Regulation (Banking Segment)*.¹ The establishment of an SLOLR and an SCDIS can strengthen the financial safety-net. Provided such a system is transparent and carefully designed, it can

¹ Available at <https://www.ifsb.org/download.php?id=4373&lang=English&pg=/index.php>.

contribute to public confidence in the system and thus limit contagion risks from Islamic banks in distress.

4. A conventional deposit insurance system (CDIS) has been established in many jurisdictions, but the business model of Islamic banks calls for certain adjustments in the way such a system is structured and operationalised. The business model of an Islamic bank differs from its conventional counterpart on both sides of the balance sheet.² Designing appropriate protection for depositors therefore requires careful consideration of Sharī'ah issues.³

5. The implementation of a well-designed Islamic deposit insurance system (IDIS) for Islamic banks is particularly challenging given the specificities of the Sharī'ah contracts and funding structures of Islamic banks. Nonetheless, an IDIS has potential to promote stability and resilience in the IFSI, as it enhances depositor⁴ confidence during times of economic shocks and general market stress. Such confidence is critical in preventing panic-induced bank runs that may lead to failures of otherwise profitable Islamic banks. Premised on this, some jurisdictions have already established an IDIS for the protection of Islamic deposits, while a number of others are in the process of introducing the same.

6. To guide the development and implementation of an effective IDIS, it is essential that standards or core principles be established. Standards in the financial sector, such as those issued by the Basel Committee on Banking Supervision (BCBS), the International Organisation of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS) and the International Association of Deposit Insurers (IADI) have become standard tools to guide regulatory and supervisory authorities (RSAs) in developing their regulatory regimes

² See Appendix B for further details.

³ See Section 2 “Definitions of Key Terms”, to ascertain the differences between general “Islamic deposits” and “investment accounts”/“investment account holders (IAHs)”.

⁴ The term “depositor” or “deposits” has been used in the *Core Principles for Effective Islamic Deposit Insurance Systems* (CPIDIS) in a general sense where it encompasses all types of funds collected by Islamic banks from individual and business customers. However, the type of deposit and investment account products covered by the IDIS varies between jurisdictions, and not all types of fund providers are necessarily accorded coverage by the IDIS. The CPIDIS duly discuss additional considerations that are specific to investment accounts and IAHs in this document, while the other discussions are from a general depositor and/or deposit perspective (see subsection 1.4.2 of this document.). See also discussion papers by the International Association of Deposit Insurers (IADI), “Insurability of Islamic Deposits and Investment Accounts” (2014) and “Sharī'ah Approaches for the Implementation of Islamic Deposit Insurance Systems” (2014). See also IFSB Working Paper No. 6, “The Role and Mechanisms of Sharī'ah-Compliant Deposit Insurance Schemes” (2016).

and practices. They also serve as the basis for RSAs themselves, or external parties such as the multilateral agencies, to assess the strength and effectiveness of these regulatory and supervisory practices.

7. The IADI is the global standard-setting body that provides benchmark standards for assessing deposit insurance systems and for identifying gaps in current practices, including measures to address them. Although the IADI *Core Principles for Effective Deposit Insurance Systems*⁵ (hereafter “IADI CPs”), revised in November 2014, are generally applicable to IDIS, there are specificities of Islamic banks and Shari’ah governance requirements that need to be specified separately.

8. In view of the above, the Council of the IFSB, in its 31st meeting held on 11 December 2017, and the IADI’s Executive Council, in its 54th meeting held on 31 January 2018, have agreed for the Secretariats of both the IFSB and the IADI to collaborate and develop an IADI–IFSB standard, *Core Principles for Effective Islamic Deposit Insurance Systems (CPIDIS)*. To support the preparation of this standard, the formation of a joint working group (JWG) was also approved comprising of nominated experts from among the IADI and IFSB member institutions, including international financial organisations.

9. Under the direction and guidance of the IFSB Technical Committee and the IADI Islamic Deposit Insurance Technical Committee, as well as review of the document by the designated IFSB Shari’ah board, the JWG has developed the CPIDIS and the associated assessment methodology, building upon the IADI CPs. The due process of this standard’s development has resulted in the identification of a number of areas in which existing IADI CPs and the assessment methodology for the conventional deposit insurance systems do not address the specificities of Islamic banks, thus confirming the need for CPIDIS.

1.2 Main Premises and Objectives of this Work

10. The main objective of the CPIDIS is to provide a set of core principles for the development and implementation of an effective IDIS, taking into consideration the specificities of Islamic banks, and drawing from the existing international standards, principally the IADI CPs. In particular, the objectives of the CPIDIS are to:

⁵ Available at <https://www.iadi.org/en/assets/File/Core%20Principles/cprevised2014nov.pdf>.

- a. serve as a benchmark international framework to facilitate the development and implementation of effective IDIS;
- b. enable the existing IDISs to identify best-practice gaps in their current modalities; and
- c. facilitate an independent, third-party or self-assessment of the compliance of an IDIS with CPIDIS.

11. The IADI and IFSB envisage that jurisdictions will use CPIDIS and their compliance assessment methodology as a benchmark for assessing the quality of their IDIS and for identifying gaps in their Islamic deposit insurance practices, including measures to address them. The CPIDIS are also envisaged to be used by the International Monetary Fund (IMF) and the World Bank, in the context of the Financial Sector Assessment Program (FSAP), to assess the effectiveness of jurisdictions' Islamic deposit insurance systems and practices. The CPIDIS may also assist IADI and IFSB member jurisdictions in: (a) self-assessment; (b) reviews conducted by third parties; and (c) peer reviews conducted, for instance, at regional level of RSAs.

12. Overall, the CPIDIS will promote further integration of Islamic deposit insurance with the international architecture for financial stability. Given the importance of consistent and effective standards implementation, the IADI and IFSB stand ready to encourage work at the national level to implement the CPIDIS in conjunction with other financial safety-net participants. The IADI and IFSB invite international financial institutions and other agencies to use the CPIDIS in assisting individual jurisdictions to develop, implement and/or strengthen their IDIS. The IADI and IFSB will continue to collaborate closely with those institutions and agencies, and remain committed to further enhancing interaction with IDIS operating in non-member jurisdictions.

1.3 General Approach of the CPIDIS

13. The starting point for development of the CPIDIS has been a careful analysis of the areas in which the IADI CPs do not fully apply to the specificities of Islamic finance in general, and to Islamic deposit insurance in particular. The principal objectives of a deposit insurance system (i.e. to provide protection for depositors and to promote the stability of the financial system) are compliant with the objectives of Shari'ah and the IDIS.⁶ The design features set out

⁶ Financial safety nets, including deposit insurance systems, aim to promote financial stability and prevent bank failures and are therefore essentially tools to protect an economy from output losses and depositors from losing their

in the IADI CPs, such as governance, membership, coverage, and sources and uses of funds, are generally consistent with the features of an effective IDIS. However, some modifications are required to take into account the Shari'ah requirements that define the heterogeneities of Islamic banking operations and the specificities of an IDIS.⁷ Moral hazard issues, operating environment and the other considerations discussed in the IADI CPs are also relevant to IDIS and are discussed from a CPIDIS context in Section 3 of this document.

14. Based on the above, one new core principle has been developed for CPIDIS concerning Shari'ah governance, while some IADI CPs have been modified at the level of principles and/or essential criteria, including the addition of new criteria. Other IADI CPs have been retained in view of their common applicability to both conventional and Islamic DIS. The text of these is given unchanged except changes, such as the use of the term "Islamic bank" instead of "bank" at some points as well as the addition of "Islamic" or "Shari'ah-compliant" before certain words describing a financial activity or practice. The table in Appendix A indicates the approach that has been taken and provides a mapping between the IADI CPs and the CPIDIS.

15. The CPIDIS are neutral with regard to different modalities⁸ for structuring Islamic deposit insurance by jurisdictions, so long as the over-arching objectives (defined in Section 1.2) are achieved. The CPIDIS are reflective of, and designed to be adaptable to, a broad range of

funds. Thus, the underlying objective of such schemes is in compliance with Shari'ah, which includes "protection of wealth" among the five essential necessities of *Maqāṣid al-Shari'ah*. See Section 3 of IFSB Working Paper No. 6 for more details.

⁷ See Appendix B: "Specificities of IDIS", for details on these heterogeneities and their implications.

⁸ IDIS may be administered as follows:

- a. on a full-fledged basis – for example, a deposit insurer that solely implements a Shari'ah-compliant system; or
- b. on an integrated basis – that is, the IDIS and CDIS are administered by a single deposit insurer that is a separate entity or as a function or unit within a central bank or supervisory authority.

For examples of practical implementation of these modalities in different jurisdictions, see the discussion paper by IADI, "Sharī'ah Approaches for the Implementation of Islamic Deposit Insurance Systems" (2014) and IFSB Working Paper No. 6, "The Role and Mechanisms of Sharī'ah-Compliant Deposit Insurance Schemes" (2016).

The choice of modality depends, among other things, on the relative size of the conventional and Islamic banking industry, as well as the availability of expertise to administer an IDIS. Where a jurisdiction establishes separate deposit insurers for conventional and Islamic banks, it will be important to put in place effective mechanisms for coordination and cooperation between the two agencies. There may also be a case where a deposit insurance system entity covers several jurisdictions. This alternative may be adopted by smaller countries that belong to the same geographical region.

jurisdictional circumstances, settings and structures. Hence, regardless of the different modalities utilised to structure an IDIS, the guidelines of the CPIDIS are applicable to the Islamic deposit insurer.

16. The CPIDIS are intended as a framework supporting effective Islamic deposit insurance practices. National authorities are free to put in place supplementary measures that they deem necessary to achieve effective Islamic deposit insurance in their jurisdictions. The CPIDIS are not designed to cover all the needs and circumstances of every Islamic financial system. Instead, specific jurisdiction circumstances should be more appropriately considered in the context of assessments and in the dialogue between assessors and jurisdiction authorities.

17. Each CPIDIS is supported by assessment criteria. A comprehensive, credible and action-oriented assessment should focus on the IDIS and its relationship to the financial safety-net functions that support it. The assessment of broader safety-net functions (i.e. operating environment) is mostly outside the responsibility of the deposit insurer. However, it can have a direct effect on the deposit insurer's ability to fulfil its mandate. The assessment of an IDIS should identify strengths and weaknesses in the existing system, and form a basis for remedial measures by deposit insurers and policymakers (e.g. government authorities or, if it is primarily a private system, its member Islamic banks), after taking into account the structural, institutional and legal features of each national IDIS.

1.4 Specific Approach of the CPIDIS

18. In approaching the guidelines in this document, the CPIDIS have undertaken certain approaches that are related to the specificities of Islamic finance. While they are duly discussed appropriately in various stages of this document, and are also backed by detailed insights in the annexes and appendices, some level of clarification at an early stage is useful to enable an informed reading, usage and implementation of the CPIDIS.

1.4.1 Scope of Islamic Banks

19. **“Islamic bank”** refers to any entity that accepts Shari’ah-compliant deposits and/or repayable funds (see subsection 1.4.2, “Treatment of Investment accounts”, below) from the public and is classified under the jurisdiction’s legal framework as a deposit-taking institution. The entity complies with the rules and principles of Shari’ah, as overseen and determined by a Shari’ah governance mechanism (see subsection 1.4.3, “Shari’ah governance”, below). The

CPIDIS are also applicable to financial institutions that do not call themselves an “Islamic bank”, but either explicitly or implicitly claim to offer Shari’ah-compliant banking services (e.g. by labelling themselves “participation banks” or “non-interest banks”, etc.).

20. In practice, Islamic banks include full-fledged Islamic banks that are licensed and established to operate as such. However, there are also separately established Islamic banking subsidiaries of conventional banks that are registered and operated as separate subsidiaries, but which have ownership ties and financial consolidation links to the parent conventional banks.

21. There are also “**Islamic banking windows**” (IBWs), which are part of a conventional financial institution (either a branch or a dedicated unit of that financial institution) but provide deposit-taking and financing/investment services on principles that comply with Shari’ah. These are not a separate legal entity and are consolidated and reported within the accounts of the conventional bank’s business.⁹ There are some differences in approach to guidelines, particularly between Islamic banks/Islamic banks’ subsidiaries and those applicable upon IBWs.

22. The specific approach of the CPIDIS is that the guidelines are applicable to all types of Islamic banks (including full-fledged banks, subsidiaries of conventional banks, and windows of conventional banks). However, where necessary, a distinction is made and additional guidance provided for IBWs, due to their unique classification.

1.4.2 Treatment of Investment Accounts

23. The funding profile of Islamic banks also includes a specific account termed an “**investment account**”, with funds being placed by IAH. This entails pooling of investable funds by the IAH with the bank for the purpose of undertaking investments carried out by the bank acting as an entrepreneur (*mudarib*) or agent (*wakil*). The profits and/or losses¹⁰ are accordingly shared by the Islamic bank and the IAHs (or agency fee duly paid to the bank), premised on the

⁹ It is important that IBWs be completely separate from their conventional parents in terms of their capital requirements and accounting for profit and loss, by ensuring that their operations are not intertwined with those of the parent. However, profits generated by the Islamic window in its capacity as *mudarib* or *wakil* can be transferred to the conventional parent in its capacity as the owner of the Islamic window.

¹⁰ In the case of *mudarabah*, it is profit sharing and loss bearing by the capital provider, as in normal cases only the capital-contributing party bears financial loss while the entrepreneur (*mudarib*) bears the loss of his or her efforts. However, the entrepreneur (*mudarib*) is liable to bear part of the financial losses that result due to his or her negligence, misconduct or breach of conditions as stipulated by the capital provider.

principles of Shari'ah governing the transaction and contracts utilised to support the investment account.

24. The regulatory and prudential treatment of investment accounts varies between jurisdictions, with some treating them as "Islamic deposits" (due to the requirements of existing legal frameworks which do not recognise investment accounts) while others recognise them as investment accounts, a separate category from deposits.¹¹ This difference in treatment has important implications, as an "Islamic deposit" product is normally provided a guarantee by the Islamic bank while also enjoying deposit insurance coverage by the Islamic deposit insurer. However, where jurisdictions have recognised and given investment accounts separate treatment, they may or may not have deposit insurance coverage. For instance, in some jurisdictions, the law explicitly mentions the term "investment accounts"; however, the regulatory and prudential treatment accorded to them is that of bank "deposits". As a result, not all types of fund providers in Islamic banks are necessarily accorded coverage by the IDIS.

25. Under CPIDIS, the term "depositor" or "deposits" or "deposit insurance" has been used in a general sense where it encompasses all types of funds (i.e. Islamic deposits and investment accounts) collected by Islamic banks from individual and business customers. However, where necessary, the CPIDIS duly discuss additional considerations that are specific to investment accounts and IAH in this document, while the other discussions are from a general depositor and/or deposits perspective. See also the detailed discussion in Annex 2 of this document pertaining to the IDIS coverage of investment accounts.

1.4.3 *Shari'ah Governance*

26. Islamic finance activities need to be under the ongoing supervision of qualified experts that are well versed in the principles of Islamic finance and Shari'ah. Accordingly, "Shari'ah governance" refers to the set of institutional and organisational arrangements through which an Islamic bank ensures that there is effective independent oversight of Shari'ah compliance over each of the undertaken activities, structures and processes. The activities/institutions may be supervised by either a Shari'ah advisor or a team of experts forming a Shari'ah board, with the particular requirements for Shari'ah supervision differing between jurisdictions.

¹¹ It is important to note, however, that the treatment of investment accounts as Islamic deposits is not a Shari'ah-compliant practice due to the nature of contract and relationship between an IIFS and customer. However, providing an investment account with deposit insurance coverage is possible provided the mechanism is Shari'ah-compliant.

27. A number of different Shari'ah governance models are currently practised,¹² including an embedded Shari'ah board within the entity (i.e. IDIS); a centralised board outside the IDIS that has recognised authority over matters of Islamic finance (e.g. the Shari'ah board of the central bank); and an external Shari'ah advisory firm¹³ guiding the entity (i.e. IDIS) in terms of the Shari'ah compliance of its operations, products and services.

28. The specific recommendations of the CPIDIS in relation to the Shari'ah governance function for the Islamic deposit insurer are provided in CPIDIS 17.

¹² For further details and insights on Shar'ah governance systems, and different approaches to it, see IFSB-10: *Guiding Principles on Shari'ah Governance Systems*. See also the IADI Discussion Paper, "Shari'ah Governance for IDIS" (February 2018).

¹³ In the case of Shari'ah governance of IDIS, this option is only applicable for countries that will not be able to meet the first two options (an embedded or centralised Shari'ah board), and subject to terms and conditions such as confidentiality, independence, avoidance of conflict of interest, etc. See CPIDIS 17 for details.

SECTION 2: DEFINITIONS OF KEY TERMS

“**Blanket guarantee**” is defined as a declaration by authorities that, in addition to the protection provided by limited coverage deposit insurance or other arrangements, certain deposits and perhaps other financial instruments will be protected.

“**Bridge bank**” refers to an entity that is established to temporarily take over and maintain certain assets, liabilities and operations of a failed bank as part of the resolution process.

“**Conventional deposit insurance system**” refers to the deposit insurer and its relationships with the financial safety-net participants that support deposit insurance functions and resolution processes.

“**Deposit insurance**” is defined as a system established to protect depositors against the loss of their insured deposits in the event that a bank is unable to meet its obligations to the depositors.

“**Deposit insurer**” refers to the specific legal entity responsible for providing deposit insurance, deposit guarantees or similar deposit protection arrangements.

“**Depositor preference**” means granting deposit liabilities a higher claim class than other general creditors against the proceeds of liquidation of an insolvent bank’s assets. Depositors must be paid in full before remaining creditors can collect on their claims. Depositor preference can take a number of different forms. For example:

- National (or domestic) depositor preference gives priority to deposit liabilities booked and payable within the domestic jurisdiction and does not extend to deposits in foreign branches abroad.
- Eligible depositor preference gives preference to all deposits meeting the eligibility requirements for deposit insurance coverage.
- Insured depositor preference gives preference to insured depositors (and the deposit insurer under subrogation).

- A two-tiered depositor preference concept, in which eligible, but uninsured, deposits have a higher ranking than claims of ordinary unsecured, non-preferred creditors, and insured depositors have a higher ranking than eligible depositors.
- General depositor preference, in which all deposits have a higher ranking than claims of ordinary unsecured, non-preferred creditors, regardless of their status (insured/uninsured or eligible/not eligible).

“Differential contribution system” (or **“risk-based contribution”**) refers to a contribution assessment system that seeks to differentiate contributions on the basis of criteria such as individual bank risk profiles.

“Ex-ante contributions” refers to the regular collection of contribution, with the aim of accumulating a fund to meet future obligations (e.g. reimbursing depositors) and cover the operational and related costs of the deposit insurer.

“Ex-post contribution” refers to systems in which funds to cover deposit insurance obligations are only collected from surviving banks after a bank failure.

“Financial safety net” is defined to include the functions of prudential regulation, supervision, resolution, lender of last resort and deposit insurance. In many jurisdictions, a department of government (generally, a Ministry of Finance or Treasury responsible for financial-sector policy) is included in the financial safety net.

“Fit and proper” refers to fitness tests that usually seek to assess the competence of boards of directors and boards of commissioners (and, where applicable, Shari’ah board members) and their capacity to fulfil the responsibilities of their positions, while propriety tests seek to assess their integrity and suitability. Formal qualifications, previous experience and track record are some of the elements focused on by authorities when determining competence. To assess integrity and suitability, elements considered include criminal record, financial position, civil actions against individuals to pursue personal debts, refusal of admission to, or expulsion from, professional bodies, sanctions applied by regulators of other similar industries, and previous questionable business practices.

“Integrated deposit insurance system” refers to IDIS and CDIS administered under a single deposit insurer, for the purpose of this standard.

“Investment accounts” refers to funds of the investors placed with an Islamic bank in a pool on the basis of *mudarabah* for the purpose of profit sharing and loss bearing by the capital provider or *musharakah* for the purpose of profit and loss sharing between the Islamic bank and investors. Where investment accounts are managed under a *wakalah* contract, the relationship between an Islamic bank and the investors is a simple agency relationship, with the Islamic bank earning a flat fee instead of sharing the profit.

- “Restricted investment accounts” refers to the accounts whose holders authorise the investment of their funds based on *muḍarabah*, *musharakah* or *wakalah* contracts with certain restrictions as to where, how and for what purpose these funds are to be invested.
- “Unrestricted investment accounts” refers to the accounts whose holders authorise the investment of their funds based on *muḍarabah*, *musharakah* or *wakalah* contracts without imposing any restrictions. The institutions can commingle these funds with their own funds and invest them in a pooled portfolio.

“Islamic banking window” is defined as part of a conventional financial institution (which may be a branch or a dedicated unit of that financial institution) that provides deposits/investment accounts to deploy/invest in financing and investment in a Shari’ah-compliant manner under their legal and regulatory framework.

“Islamic deposit” is a product offered by Islamic banks to clients that entails a contractual obligation on the bank to repay either the full principal amount or part of it, as demanded by the clients from time to time, from their deposited funds with the bank.

“Islamic deposit insurance” is defined as a system established with the Shari’ah-compliant design features to protect depositors against the loss of their insured Islamic deposits in the event that an Islamic bank is unable to meet its obligations to the depositors.

“Islamic deposit insurance system” refers to the deposit insurer and its relationships with the financial safety-net participants that support Islamic deposit insurance functions and resolution processes.

“Kafalah” refers to a guarantee – for example, when a person guarantees a liability or duty (especially debt) of another person.

“Liquidation” (or **“receivership”**) refers to the winding down (or “winding up”, as used in some jurisdictions) of the business affairs and operations of a failed bank through the orderly disposition of its assets after its licence has been revoked and it has been placed in receivership. In most jurisdictions, it is synonymous with “receivership”.

“Liquidator” (or **“receiver”**) refers to the legal entity that undertakes the winding down of the failed bank and the disposition of its assets.

“Mandate” of the deposit insurer refers to the set of official instructions describing its roles and responsibilities. There is no single mandate or set of mandates suitable for all deposit insurers. When assigning a mandate to a deposit insurer, jurisdiction-specific circumstances must be taken into account. Mandates can range from narrow “pay box” systems to those with extensive responsibilities, such as preventive action and loss or risk minimisation/management, with a variety of combinations in between. These can be broadly classified into four categories:

- a. a “pay box” mandate, where the deposit insurer is only responsible for the reimbursement of insured deposits;
- b. a “pay box plus” mandate, where the deposit insurer has additional responsibilities, such as certain resolution functions (e.g. financial support);
- c. a “loss minimiser” mandate, where the insurer actively engages in a selection from a range of least-cost resolution strategies; and
- d. a “risk minimiser” mandate, where the insurer has comprehensive risk minimisation functions that include risk assessment/management, a full suite of early intervention and resolution powers, and in some cases prudential oversight responsibilities.

“Moral hazard” arises when parties have incentives to accept more risk because the costs that arise from the risk are borne, in whole or in part, by others.

“Mudarabah” refers to a partnership contract between the capital provider (*rabb al-mal*) and an entrepreneur (*muḍarib*) whereby the capital provider would contribute capital to an enterprise or activity that is to be managed by the entrepreneur. Profits generated by that enterprise or activity are shared in accordance with the percentage specified in the contract, while losses are to be

borne solely by the capital provider unless the losses are due to misconduct, negligence or a breach of contracted terms.

“Public policy objectives” refers to the goals that the deposit insurance system is expected to achieve.

“Resolution” refers to the disposition plan and process for a non-viable/failed bank. Resolution may include liquidation and depositor reimbursement, transfer and/or sale of assets and liabilities, the establishment of a temporary bridge institution, and the write-down of debt or conversion to equity. Resolution may also include the application of procedures under insolvency law to parts of an entity in resolution, in conjunction with the exercise of resolution powers.

“Resolution authority” is defined as a public authority that, either alone or together with other authorities, is responsible for the resolution of financial institutions established in its jurisdiction (including resolution planning functions).

“Shari’ah” in this document refers to the Shari’ah-compliance framework applicable to Islamic banks of a jurisdiction, prescribed by their RSA as per the Shari’ah deduced from legitimate sources: the Qur’an, Sunnah, consensus (*ijma’*), analogy (*qiyas*) and other approved sources of the Shari’ah.

“Subrogation” is the substitution of one party (e.g. the deposit insurer) for another (e.g. the insured depositor) with reference to a lawful claim, demand or right, so that the party that substitutes succeeds to the rights of the other in relation to the debt or claim, and its rights and remedies.

“Takaful” refers to a mutual guarantee in return for the commitment to donate an amount in the form of a specified contribution to the participants’ risk fund, whereby a group of participants agree among themselves to support one another jointly for the losses arising from specified risks.

“Target fund size” refers to the size of the ex-ante deposit insurance fund, typically measured as a proportion of the assessment base (e.g. total or insured deposits), sufficient to meet the expected future obligations and cover the operational and related costs of the deposit insurer.

“*Wakalah*” refers to an agency contract where the customer (principal) appoints an institution as agent (*wakīl*) to carry out the business on his behalf. The contract can be with or without a fee.

SECTION 3: MORAL HAZARD, OPERATING ENVIRONMENT AND OTHER CONSIDERATIONS

3.1 Minimising Moral Hazard

29. A well-designed financial safety net contributes to the stability of the financial system. However, if poorly designed, it may increase risks, notably moral hazard. Moral hazard arises when parties have incentives to accept more risk because the costs are borne, in whole or in part, by others. In the context of deposit insurance, protecting depositors from the threat of loss (e.g. through explicit limited deposit insurance or the belief that banks will not be allowed to fail) insulates them from the consequences of unsafe and unsound bank practices, and can lead to greater risk taking by banks than might otherwise be the case.

30. In the context of IDIS, the protection for depositors from the threat of loss by the deposit insurer may reduce market discipline. In addition, the implicit protection and the belief in certain jurisdictions that banks will not be allowed to fail may lead banks to take greater risks than might otherwise be the case.

31. The greater risk taking by Islamic banks may be more prevalent in jurisdictions that provide IDIS coverage for IAHs, particularly when the contributions for the investment account coverage are not provided by the Islamic banks in some jurisdictions (see discussion in Annex 2 of this document).

32. The IDIS, therefore, must be designed to mitigate the impact of moral hazard on the behaviour of shareholders, Islamic bank management and depositors, while recognising that most depositors are typically less able to differentiate between safe and unsafe Islamic banks. Such mitigation is a function of the overall design of the system. Moral hazard is also mitigated by other safety-net participants.

33. More specifically, key design features of the deposit insurance system, described in these CPIDIS, aim at mitigating moral hazard. Examples include, but are not restricted to: limited coverage levels and scope; differential contributions; and timely intervention and resolution by the deposit insurer or other participants with such powers in the safety net.

34. The financial safety net creates and supports appropriate incentives to mitigate moral hazard through several mechanisms, including: the promotion of good corporate governance and sound risk management at individual banks; holding the parties at fault responsible for losses; effective market discipline; and the frameworks for, and enforcement of, strong prudential regulation, supervision, resolution, and laws and regulations.

35. The assessment of the extent to which moral hazard affects a deposit insurance system is based on an overall evaluation of the effectiveness of supervision, the legal framework, and the early warning, intervention and resolution regimes.

3.2 Operating Environment

36. The effectiveness of an Islamic deposit insurance system is influenced not only by its design features but also by the environment within which it operates. The operating environment includes macroeconomic conditions, the strength of the sovereign, the financial system structure, prudential regulation and supervision, Shari'ah governance regime, the legal and judicial framework, and the accounting and disclosure system. The operating environment is largely outside the scope of authority of the deposit insurer. However, it influences the deposit insurer's ability to fulfil its mandate and determines, in part, its effectiveness in protecting depositors and contributing to a jurisdiction's financial stability.

37. While the operating environment is not formally assessed (and there is no corresponding compliance determination), it forms the foundation for the assessment of compliance with the CPIDIS. The conditions outlined in this section must be thoroughly analysed in order to make an accurate assessment of the appropriateness and effectiveness of the design and operation of the overall system. Identically designed deposit insurance systems may have a very different impact on financial stability and depositor protection, reflecting differences in the environment within which they operate.

3.2.1 Macroeconomic Conditions

38. Macroeconomic conditions influence the effectiveness of markets, the ability of the financial system to intermediate resources, and economic growth. Persistent instability hampers the functioning of markets, and such conditions affect the ability of financial institutions to absorb and manage their risks. In periods of economic instability, market volatility can lead to destabilising creditor runs (including depositor runs). Moreover, uncertainties about future

movements in relative prices, including asset prices and exchange rates, can make it difficult to determine the medium-term viability of an institution.

39. In stable periods, the CPIDIS provide guidance on minimum features for an effective IDIS. The IDIS supports depositor confidence in the face of idiosyncratic Islamic bank failures. In the face of persistent macroeconomic instability, however, the CPIDIS provide guidance on areas that an IDIS will need to reinforce, in order to provide robust support to depositors in general. The system may require a variety of enhancements, including larger-than-usual reserves, stronger emergency funding options, and close coordination and participation with other safety-net participants in reinforcing financial stability. Introduction of an IDIS under these conditions, however, will have to be considered carefully, as the new system, if it is not supported by the necessary institutional reforms, could be discredited and fail to bolster depositor confidence.

40. Evaluations of the macroeconomic conditions in a jurisdiction are found in the jurisdiction reports of international organisations such as the IMF, the World Bank and the Organisation for Economic Co-operation and Development (OECD). These reports often include an analysis of recent conditions and projections of the likely path for macroeconomic variables.

3.2.2 Structure of the IFSI

41. The soundness of a financial system influences the appropriate design features of a deposit insurance system. Any assessment of an IDIS should consider the health and structure of the Islamic financial sector, and the range of possible demands on the deposit insurer. Elements for consideration include:

- a. An assessment of the health of Islamic banks based on an evaluation of capital adequacy, liquidity and credit quality of the Islamic financial system. The resources of the deposit insurer, its ability to identify emerging threats, and its relationships with other safety-net participants must be strong. Similarly, the location or currency composition of deposits, and related coverage and reimbursement rules, will influence how resources are maintained by the insurer.
- b. The structure of the Islamic financial system in terms of the number, type and characteristics of Islamic banks, and types of deposits/investment accounts and depositors/IAHs covered. This information has implications for the assessment of the strength and effectiveness of the deposit insurer. The extent of

interconnectedness, competition and concentration within the system will all influence the possibilities for contagion and systemic shocks. The presence of poorly supervised Islamic banks can lead to unidentified risks to the financial system that materialise unexpectedly. The deposit insurance system should be designed to take account of these risks.

- c. Any pre-existing depositor protection arrangements (e.g. depositor preference and institutional protection arrangements) and the effect of these arrangements on the introduction or reform of a deposit insurance system.

42. The assessment of an IDIS would also depend on the following considerations regarding the structure of the IFSI:

a. Shari'ah framework within which the IFSI operates

A robust Shari'ah framework in a jurisdiction will facilitate the effective implementation of Islamic finance, including an IDIS. The framework should, among other things, provide mechanisms for how the differing Shari'ah interpretations within a jurisdiction can be resolved so as to promote greater acceptability of Islamic finance practices and to avoid confusion.

b. The implementation of the IDIS in a dual banking system where Islamic banks operate alongside the conventional banks

In a jurisdiction with a dual banking system and where the IDIS and the CDIS are implemented separately, both systems should be designed in such a way as to promote a level playing field and avoid regulatory arbitrage. The deposit insurer needs to understand, among other things, the number, types and characteristics of Islamic banks, as well as the types of deposits and depositors to be covered for the purpose of determining the appropriate coverage level.

c. Well-functioning Islamic money and capital markets

To sustain Islamic banks' health in terms of capital and liquidity management, the Islamic money and capital markets must be functioning effectively well to ensure that a broad range of Shari'ah-compliant financial instruments are available to the

Islamic banks. This would also apply to the IDIS, since the deposit insurer would also require the availability of such financial instruments for investment purposes. In many jurisdictions, Shari'ah-compliant money markets and secondary markets for trading Shari'ah-compliant financial instruments are underdeveloped or even absent.

d. Pre-existing consumer protection arrangements

The effect of these arrangements on the introduction or reform of an IDIS (e.g. depositor preference, institutional protection arrangements, the order of priority for different classes of deposits and the treatment for an IAH's assets that are managed separately).

43. The assessment and description of the IFSI including Islamic banks can come from a variety of sources. The jurisdiction itself should evaluate and assess the strength and soundness of the system, although institution-specific information may not be publicly available. In addition, country reports by international organisations such as the IMF or the World Bank, or the IFSB's annual *IFSI Stability Report* will also contain a description of the Islamic financial sector and recommendations to address any risks and deficiencies.

3.2.3 Prudential Regulation, Supervision and Resolution

44. Strong prudential regulation and supervision can mitigate moral hazard and ensure that any Islamic bank's weaknesses are promptly identified and corrected. In addition to dealing with the risks that are common to conventional banking, such as credit, market, operational and liquidity risks, supervisors are required to address the unique risks of Islamic banks such as equity investment risk, displaced commercial risk and Shari'ah non-compliance risk. The implementation of early detection and intervention, and of corrective measures, is essential; however, where such measures are deficient, an effective resolution regime can help to lower the costs of failure.

45. Islamic banks can conduct banking business in different ways, such as through equity participation or the holding of inventories from trading activities. Nevertheless, supervisors should regulate Islamic banks such that they do not adversely impact the stability of the financial

system. Any proportionality in the regulatory treatment with a view to supporting the development of Islamic banks should also weigh against the need for financial stability.

46. The supervisory authority should have an effective licensing or chartering regime for new institutions, conduct regular and thorough examinations of individual Islamic banks, and have an effective early warning system. All Islamic banks within the safety net should be subjected to an effective resolution regime. Sound governance of agencies comprising the safety net should also be in place, to strengthen the financial system's architecture and contribute directly to financial stability.

47. The system of prudential regulation, supervision and resolution should be in compliance with international standards, including the IFSB's *Core Principles for Islamic Finance Regulation (Banking Segment)*,¹⁴ the BCBS's *Core Principles for Effective Banking Supervision* and the Financial Stability Board's (FSB's) *Key Attributes of Effective Resolution Regimes*. In the absence of recent external reviews, such as FSAP or FSB reviews, jurisdictions may also have useful self-assessments or reports laying out the existing structure and gaps compared to international standards

3.2.4 *The Legal and Judicial Framework*

48. A robust and effective legal framework is manifested by, among other things, the existence of relevant and comprehensive laws, legal certainties and significant consistencies in the legal regime. A well-developed legal framework should incorporate a system of business laws, including corporate, insolvency, contract, creditor rights, consumer protection, anti-corruption/fraud and private property laws. The legal system should be supported by a well-functioning judiciary.

49. For IDIS, the legal framework must lay out the powers that can compel Islamic banks to comply with their obligations as members of an IDIS. Jurisdictions may provide these powers in a single law that caters for both the IDIS and the CDIS, or provide them under separate laws.

50. Effective bank insolvency laws include a special resolution regime (SRR) for Islamic banks that is separate from the general corporate insolvency laws. An SRR is needed so that

¹⁴ Available at <https://www.ifsb.org/download.php?id=4373&lang=English&pg=/index.php>.

the resolution authorities can act promptly to limit contagion and maintain financial stability. It can also be important in ensuring consistency between the supervisory and insolvency related functions of the safety-net authorities.

51. The effectiveness of a legal system is often highlighted in reports by international organisations such as the IMF and the World Bank. Local attorneys also have insight about the length of time cases take, the ability or authority of courts to reverse decisions by regulators, the credibility of the legal process, and the appropriateness of the legal system for modern financial markets.

3.2.5 The Accounting and Disclosure Regime

52. Sound accounting and disclosure regimes are necessary for the effective evaluation of risks by deposit insurance systems. Accurate, reliable and timely information enables management, depositors, the market and authorities to make decisions regarding the risk profile of an institution, and thereby increase market, regulatory and supervisory discipline. A sound accounting and disclosure regime includes comprehensive and well-defined accounting principles and rules that command wide international acceptance.

53. A system of independent audits ensures that the users of financial statements have an independent assurance that the accounts provide a true and fair view of the financial position of the Islamic banks. They also ensure that reports are prepared according to established accounting principles, with auditors held accountable for their work. The lack of strong accounting and disclosure regimes can make risk identification difficult. All financial safety-net participants, including the Islamic deposit insurer, need to have timely access to reliable financial information.

SECTION 4: CORE PRINCIPLES AND COMPLIANCE ASSESSMENT

CPIDIS 1: PUBLIC POLICY OBJECTIVES

The principal public policy objectives for **Islamic deposit insurance systems** are to protect depositors and contribute to financial stability. These objectives should be formally specified and publicly disclosed. The design of the **Islamic deposit insurance system** should reflect the system's public policy objectives **while being in conformity with Shari'ah requirements.**¹⁵

Essential criteria

1. The public policy objectives of the Islamic deposit insurance systems are clearly and formally specified and made public, for example, through legislation or documents supporting the legislation.
2. The design of the Islamic deposit insurance system is consistent with the system's public policy objectives **while being in conformity with Shari'ah rules and principles, as reviewed and endorsed through a Shari'ah governance system outlined in CPIDIS 17.**¹⁶
3. There is a review of the extent to which an Islamic deposit insurance system meets its public policy objectives.¹⁷ This involves both an internal review conducted on a regular basis by the governing body and an external review conducted periodically by an external body (e.g. the body to which the deposit insurer is accountable or an independent entity with no conflicts of interest, such as an auditor general). Any review must take into consideration the views of key stakeholders, including **a Shari'ah governance system.**

¹⁵ In situations where conflicts may arise between meeting public policy objectives and Shari'ah requirements, CPIDIS expect the deposit insurer to give appropriate emphasis to achieving the public policy objectives. Different design features of IDIS arising from applying and complying with the rules of certain Shari'ah arrangements or contracts (e.g. *takaful* and *kafalah*) may not be consistent with the public policy objectives. As an example of this conflict, under CPIDIS 16, the deposit insurer is expected to recover claims through subrogation. However, subrogation may not be allowed under certain Shari'ah arrangements of the IDIS.

¹⁶ There is no one-size-fits-all approach to ensuring Shari'ah governance process. See CPIDIS 17 for details and approaches.

¹⁷ The timing of regular reviews will depend on jurisdiction-specific factors but should occur at least every five years, or more frequently as deemed necessary.

4. If additional public policy objectives are incorporated, they do not conflict with the two principal objectives of protecting depositors and contributing to the stability of the financial system.

CPIDIS 2: MANDATE AND POWERS

The mandate and powers of the deposit insurer should support the public policy objectives and be clearly defined and formally specified in legislation.

Essential criteria

1. The mandate and powers of the deposit insurer are formally and clearly specified in legislation, and are consistent with stated public policy objectives.
2. The mandate clarifies the roles and responsibilities of the deposit insurer and is aligned with the mandates of other safety-net participants.¹⁸
3. The powers of the deposit insurer support its mandate and enable the deposit insurer to fulfil its roles and responsibilities.
4. The powers of the deposit insurer include, but are not limited to:
 - a. assessing and collecting contributions, levies or other charges;
 - b. transferring deposits to another **Islamic bank**;¹⁹

¹⁸ Mandates can range from narrow “pay box” systems to those with extensive responsibilities, such as preventive action and loss or risk minimisation/management, with a variety of combinations in between. These can be broadly classified into four categories:

- a. a “pay box” mandate, where the deposit insurer is only responsible for the reimbursement of insured deposits;
- b. a “pay box plus” mandate, where the deposit insurer has additional responsibilities such as certain resolution functions (e.g. financial support);
- c. a “loss minimiser” mandate, where the insurer actively engages in a selection from a range of least-cost resolution strategies; and
- d. a “risk minimiser” mandate, where the insurer has comprehensive risk minimisation functions that include risk assessment/management, a full suite of early intervention and resolution powers, and, in some cases, prudential oversight responsibilities.

¹⁹ Islamic banks include full-fledged Islamic banks as well as separately established Islamic banking subsidiaries of conventional banks. They also include Islamic windows subject to the country’s legal framework and regulatory provisions. See CPIDIS 7, Essential Criteria 1. See also the discussion in subsection 1.4.1.

- c. acquiring, holding, managing and investing the Islamic deposit insurance system's resources²⁰;
- d. reimbursing insured depositors;
- e. obtaining directly from Islamic banks timely, accurate and comprehensive information necessary to fulfil its mandate;
- f. receiving and sharing timely, accurate and comprehensive information within the safety net, and with applicable safety-net participants in other jurisdictions;
- g. compelling Islamic banks to comply with their legally enforceable obligations to the deposit insurer (e.g. provide access to depositor information), or requesting that another safety-net participant do so on behalf of the deposit insurer;
- h. setting operating budgets, policies, systems and practices;
- i. entering into contracts; and
- j. where applicable, performing a bank resolution process, which is Shari'ah-compliant, in collaboration with other safety-net agencies.

²⁰ IDIS can be implemented under different Shari'ah arrangements. The different arrangements give rise to, among other things, different ownership status of the fund; that is, the fund is owned by the deposit insurer (*kafalah* arrangement), or the fund is not owned but is managed by the deposit insurer (*takaful* arrangement). Where an Islamic deposit insurance fund [IDIF] is not owned by an IDIS, CPIDIS 2 requires that it is formally and clearly specified in legislation that the deposit insurer is allowed to utilise the fund for the implementation of the IDIS.

CPIDIS 3: GOVERNANCE²¹

The deposit insurer should be operationally independent, well-governed, transparent, accountable, and insulated from external interference.

Essential criteria

1. The deposit insurer is operationally independent. It is able to use its powers without interference from external parties to fulfil its mandate. There is no government, central bank, supervisory or industry interference that compromises the operational independence of the deposit insurer.
2. The governing body of the deposit insurer²² is held accountable to a higher authority.
3. The deposit insurer has the capacity and capability (e.g. human resources, operating budget and salary scales sufficient to attract and retain qualified staff) to support its operational independence and the fulfilment of its mandate.
4. The deposit insurer is well-governed and subject to sound governance practices, including appropriate accountability, internal controls, transparency and disclosure regimes. The institutional structure of the deposit insurer minimises the potential for real or perceived conflicts of interest.
5. The deposit insurer operates in a transparent and responsible manner. It discloses and publishes appropriate information for stakeholders on a regular basis.²³

²¹ CPIDIS 3 does not include in its scope the aspects of “Shari’ah governance” which is introduced and discussed separately in CPIDIS 17. The separation is maintained in case a jurisdiction does not have a Shari’ah governance system due to jurisdiction-specific challenges, but has a well and robust general governance framework – in this scenario it should not fail assessment of CPIDIS 3. However, it will be assessed appropriately on Shari’ah governance matters in CPIDIS 17. Need to mention that even in the presence of Shariah Governance system, the DI system should not fail compliance with CPDIS 3, and therefore, compliance to Shariah Governance system (CPDIS 17) shall not substitute a compliance to CPDIS 3, rather both principles present a complement to each other.

²² This document refers to a governance structure composed of a governing body such as a board of directors. There are significant differences across jurisdictions in the legislative and regulatory frameworks covering these functions. Some jurisdictions use a two-tier board structure, in which the supervisory function of the board is performed by a separate entity, known as a supervisory board, which has no executive functions. Other jurisdictions, by contrast, use a one-tier board structure in which the board has a broader role. Owing to these differences, this document does not advocate a specific governing body structure.

²³ Examples of appropriate information include reports on strategic objectives and plans, governance structure and practices, and annual reports that contain financial statements and describe activities during the reporting period.

6. The governing statute or other relevant laws and policies governing the deposit insurer specify that:
 - a. the governing body and management are “fit and proper” persons;
 - b. members of the governing body and the head(s) of the deposit insurer (with the exception of ex-officio appointees) are subject to fixed terms, which are staggered;²⁴
 - c. there is a transparent process for the appointment and removal of the members of the governing body and head(s) of the deposit insurer. Members of the governing body and head(s) of the deposit insurer can be removed from office during their term only for reasons specified or defined in law, internal statutes or rules of professional conduct, and not without cause; and
 - d. members of the governing body are subject to high ethical standards and comprehensive codes of conduct to minimise the potential for real or perceived conflicts of interest.²⁵
7. The deposit insurer is regularly assessed on the extent to which it meets its mandate, and is subject to regular internal and external audits.
8. The composition of the governing body minimises the potential for real or perceived conflicts of interest. To maintain operational independence, representatives of the other financial safety-net organisations that participate in the governing body do not serve as chair or constitute a majority.
9. The governing body holds regular meetings to oversee and manage the affairs of the deposit insurer (e.g. on a quarterly basis, or more frequently as deemed necessary).

²⁴ An arrangement whereby only a certain number of members of a governing body are appointed/elected in any given year. For example, a governing body may have 11 members serving staggered terms, where two new members are appointed each year.

²⁵ See also CPIDIS 11, Essential Criteria 3.

CPIDIS 4: RELATIONSHIPS WITH OTHER SAFETY-NET PARTICIPANTS

In order to protect depositors and contribute to financial stability, there should be a formal and comprehensive framework in place for the close coordination of activities and information sharing, on an ongoing basis, between the deposit insurer and other financial safety-net participants.

Essential criteria

1. Ongoing information sharing and the coordination of actions is explicit and formalised through legislation, regulation, memoranda of understanding, legal agreements or a combination thereof.
2. Rules regarding confidentiality of information apply to all safety-net participants and the exchange of information among them. Confidentiality of information is protected by law or through agreements so as not to prevent information sharing within the safety net.
3. Safety-net participants exchange information on an ongoing basis, and in particular when material supervisory actions are being taken in respect of member Islamic banks.
4. In situations where there are multiple deposit insurers operating in the same national jurisdiction, appropriate information sharing and coordination arrangements among those deposit insurers are in place.

CPIDIS 5: CROSS-BORDER ISSUES

Where there is a material presence of foreign **Islamic banks** in a jurisdiction, formal information sharing and coordination arrangements should be in place among deposit insurers in relevant jurisdictions.

Essential criteria

1. Where there is a material presence of foreign Islamic banks (i.e. subsidiaries or branches), formal information sharing and coordination arrangements are in place among relevant deposit insurers and relevant safety-net participants, subject to confidentiality provisions.
2. In circumstances where a deposit insurer is responsible for coverage of deposits in a foreign jurisdiction, or where more than one deposit insurer is responsible for coverage in a jurisdiction, bilateral or multilateral agreements exist to determine which deposit insurer(s) is/are responsible for the reimbursement process, setting levies and **contributions**, and public awareness.
3. **Coordination arrangements and/or bilateral or multilateral agreements clarifies the type of covered deposits, including, but not limited to, investment accounts and IAHs,²⁶ and also differences in treatment (if any) due to different Shari'ah interpretations by respective Shari'ah boards.**

²⁶ See CPIDIS 8, Essential Criterion 2 and CPIDIS 14, Essential Criterion 10.

CPIDIS 6: DEPOSIT INSURER'S ROLE IN CONTINGENCY PLANNING AND CRISIS MANAGEMENT

The deposit insurer should have in place effective contingency planning and crisis management policies and procedures to ensure that it is able to effectively respond to the risk of, and actual, **Islamic bank failures** and other events. The development of system-wide crisis preparedness strategies and management policies should be the joint responsibility of all safety-net participants. The deposit insurer should be a member of any institutional framework for ongoing communication and coordination involving financial safety-net participants related to system-wide crisis preparedness and management.

Essential criteria

1. The deposit insurer has its own effective contingency planning and crisis management policies and procedures in place to ensure that it is able to effectively respond to the risk of, and actual, Islamic bank failures and other events.
2. The deposit insurer develops and regularly tests its own contingency planning and crisis management plans.
3. The deposit insurer is a member of any institutional framework for ongoing communication and coordination involving safety-net participants related to system-wide crisis preparedness and management.
4. The deposit insurer participates in regular contingency planning and simulation exercises related to system-wide crisis preparedness and management involving all safety-net participants.
5. The deposit insurer participates in the development of pre- and post-crisis management communication plans involving all safety-net participants, to ensure comprehensive and consistent public awareness and communications.

6. The deposit insurer complies with Shari'ah rules and principles in its contingency planning and crisis management activities,²⁷ as reviewed and endorsed by the Shari'ah governance system outlined in CPIDIS 17.

²⁷ For further explanation of these Shari'ah rules and principles for a deposit insurer to comply with, see IFSB Working Paper No. 7, "Recovery, Resolution and Insolvency Issues for Institutions Offering Islamic Financial Services."

CPIDIS 7: MEMBERSHIP

Membership in an Islamic deposit insurance system should be compulsory for all Islamic banks.

Essential criteria

1. Membership in an **Islamic deposit insurance system** is compulsory for all **Islamic banks**, including **Islamic banking windows**²⁸ and state-owned **Islamic banks** (with or without explicit guarantees that are in line with the Shari'ah principles), and all **Islamic banks** are subject to sound prudential regulation and supervision.²⁹
2. If upon entry to a newly established **Islamic deposit insurance system**, an **Islamic bank** does not comply with all the supervisory or membership requirements, it is required to have a credible plan to address any deficiencies within a prescribed time frame (e.g. one year).
3. The conditions, process and time frame for attaining membership are explicitly stated and transparent.
4. If the deposit insurer is not responsible for granting membership in the **Islamic deposit insurance system**, the law or administrative procedures describe a clear and reasonable time frame within which the deposit insurer is consulted or informed in advance, and is given sufficient information about an application for a new licence.
5. When membership is cancelled upon the revocation or surrender of an **Islamic bank's** licence, immediate notice is given to depositors to inform them that existing deposits will continue to be insured up to a specified deadline.³⁰
6. When membership is terminated by the deposit insurer, arrangements are in place to coordinate the immediate withdrawal of the **Islamic bank's** deposit-taking licence by the

²⁸ IBWs of CDIS members are not a separate legal entity. However, for the purpose of the CPIDIS they should be members of the IDIS for deposits protection if the legal framework and regulations permit.

²⁹ The determination of "sound prudential regulation and supervision" is made by ensuring there is high compliance with the IFSB *Core Principles for Islamic Banking* (see IFSB-17: CPIFR).

³⁰ See also CPIDIS 10, "Public Awareness."

relevant authority. Upon termination, immediate notice is given to depositors to inform them that existing deposits will continue to be covered up to a specified deadline.

CPIDIS 8: COVERAGE

Policymakers should define clearly the level and scope of coverage. Coverage should be limited and credible, and cover the large majority of depositors, but leave a substantial amount of deposits exposed to market discipline. Coverage should be consistent with the Islamic deposit insurance system's public policy objectives and related design features.

Essential criteria

1. Insured deposits are clearly and publicly defined in law or regulation and reflect the public policy objectives. This definition includes the level and scope of coverage. If certain types of deposits and depositors are ineligible for deposit protection, they are clearly specified, easily determined and do not affect the speed of reimbursement.³¹
2. **The coverage status of investment accounts is formally and clearly defined based on public policy objectives. If an investment account is covered, the deposit insurer ensures that appropriate design features in conformity with Shari'ah rules and principles are in place for such coverage.**³²
3. The level and scope of coverage are limited and are designed to be credible in order to minimise the risk of runs on **Islamic banks** and undermining market discipline. The level and scope of coverage are set so that the large majority of depositors across Islamic banks are fully protected while leaving a substantial proportion of the value of deposits unprotected.³³ If a substantial proportion of the value of deposits is protected, moral hazard is mitigated by strong regulation and supervision, as well as by the other design features of **the** Islamic deposit insurance system.³⁴

³¹ In particular, some specific types of deposits may be excluded or considered ineligible for protection. These may include: interbank deposits; deposits of government departments and of regional, provincial and municipal governments and other public bodies; deposits of individuals who are regarded as responsible for the deterioration of an institution, including deposits belonging to the directors, managers, large shareholders and auditors of banks; and bearer deposits.

³² The key considerations for investment accounts under the IDIS is provided in Annex 2.

³³ For additional guidance on setting coverage limits, scope and foreign currency deposits coverage, see IADI, *Enhanced Guidance for Effective Deposit Insurance Systems: Deposit Insurance Coverage* (2013.).

³⁴ Strong regulation and supervision are demonstrated by a high level of compliance with the IFSB *Core Principles for Banking* (see IFSB-17: CPIFR).

4. The deposit insurer applies the level and scope of coverage equally to all its member Islamic banks. The coverage limit by a single deposit insurer³⁵ applies equally to both its conventional deposit insurance system and Islamic deposit insurance system.
5. The deposit insurer does not incorporate coinsurance.
6. The level and scope of coverage are reviewed periodically (e.g. at least every five years) to ensure that it meets the public policy objectives of the Islamic deposit insurance system.
7. In the event of, or prior to, a merger or amalgamation of separate Islamic banks that are members of the same Islamic deposit insurance system, depositors of the merged or amalgamated Islamic banks enjoy separate coverage (up to the maximum coverage limit) for each of the banks for a limited but publicly stated period, as defined in law or regulation. Merging Islamic banks must be held responsible for notifying the affected depositors, including informing them of the date on which the separate coverage will expire.
8. The residency status or nationality of depositors has no effect on coverage.
9. Where there are multiple deposit insurers operating in the same national jurisdiction, any differences in coverage across banks operating within that jurisdiction do not adversely affect overall deposit insurance system effectiveness and financial stability.
10. Foreign currency deposits are insured if they are widely used in a jurisdiction.
11. In cases where there is a blanket guarantee in place, there is a credible plan to transition from that blanket guarantee to a limited coverage deposit insurance system. This includes:
 - a. an assessment of the economic environment as it affects the financial system, which is conducted before a jurisdiction begins the transition from a blanket guarantee to limited coverage;

³⁵ While a single deposit insurer may have both CDIS and IDIS, it is essential to ensure that the funds of both these schemes are separate and that separation of assets/accounts is in effect. See CPIDIS 9, EC 8.

- b. the pace of the transition to limited coverage is consistent with the state of the financial industry, prudential regulation and supervision, the legal and judicial framework, and accounting and disclosure regimes;
- c. policymakers have effective communication strategies to mitigate adverse public reaction to the transition; and
- d. where there is a high level of capital mobility, and/or a regional integration policy, the decision to lower coverage limits and/or scope considers the effects of different jurisdictions' protection levels and related policies.

CPIDIS 9: SOURCES AND USES OF FUNDS

The deposit insurer should have readily available funds and all funding mechanisms necessary to ensure prompt reimbursement of depositors' claims, including assured liquidity funding arrangements. Responsibility for paying the cost of deposit insurance should be borne by **Islamic banks**.

Essential criteria

1. Funding for the **Islamic deposit insurance system** is provided on an ex-ante basis. Funding arrangements are clearly defined and established in law or regulation.
2. Funding the **Islamic deposit insurance system** is the responsibility of the member **Islamic banks**.
3. **If investment accounts are covered, the deposit insurer determines the source of contributions for such coverage (e.g. whether Islamic banks, IAHs or both), consistent with Shari'ah requirements.**³⁶
4. Initial "start-up" or "seed" funding (e.g. **from the conventional deposit insurance system administered by a deposit insurer administering an integrated system**, government or international donor organisations) is permitted to help establish an **Islamic deposit insurer**. Any start-up funding provided should be fully repaid (**if required and without any interest payment on the principal funding amount**), before the **Islamic deposit insurance system** reduces any or all **Islamic banks' contributions**.
5. Emergency funding arrangements for the **Islamic deposit insurance system**, including pre-arranged and assured sources of Shariah-compliant liquidity funding, are explicitly set out (or permitted) in law or regulation. Sources may include inter-fund borrowing,³⁷ a funding agreement with the government, the central bank or **market-based financing**. If **market-based financing** is used, **it is through Shari'ah-compliant mechanisms and is not**

³⁶ Key considerations for investment accounts is provided in Annex 2.

³⁷ Inter-fund borrowing is a potential source of funding for a deposit insurer that administers multiple funds – for example, borrowing by the Islamic fund from the conventional fund, or borrowing from a fund for the protection of Islamic deposits for the fund for the protection of investment accounts when these are managed separately. In all cases, the borrowing mechanism must be Shari'ah-compliant.

be the sole source of funding.³⁸ The arrangement for emergency liquidity funding is set up in advance, to ensure effective and timely access when required.

6. After establishing an ex-ante **Islamic deposit insurance fund**:
 - a. the target fund size is determined on the basis of clear, consistent and transparent criteria, which are subject to periodic review;
 - b. a reasonable time frame is set to achieve the target fund size; and
 - c. **the target size of IDIF is determined separately from that of the CDIF.**

7. **The deposit insurer has the responsibility for the sound investment of the IDIF, consistent with the principles of Shari'ah and in line with its Shari'ah governance system.**³⁹ The deposit insurer has a defined investment policy for its funds that aims at ensuring:
 - a. the preservation of fund capital and maintenance of liquidity; and
 - b. that adequate risk management policies and procedures, internal controls, and disclosure and reporting systems are in place.

8. The deposit insurer has the responsibility for the sound management of the **IDIF, consistent with the principles of Shari'ah and in line with its Shari'ah governance system.**⁴⁰
 - a. **Where both conventional and Islamic deposit insurance systems operate, the deposit insurer segregates IDIF from CDIF, as well as maintains separate records for each fund.**
 - b. **The deposit insurer also uses an appropriate basis⁴¹ to allocate permissible expenditures between IDIF and CDIF.**

³⁸ Where applicable (e.g. the European Union), deposit insurers may borrow from each other's funds.

³⁹ See CPIDIS 17 on Shari'ah governance.

⁴⁰ Ibid.

9. The deposit insurer may hold funds in the central bank **in conformity with Shari'ah rules and principles**. The deposit insurer establishes and complies with rules to limit significant investments in **Islamic** banks.

10. Where the deposit insurer is not the resolution authority, it has the option, within its legal framework, to authorise the use of its funds for resolution of **member Islamic banks** other than by liquidation.⁴² In such situations, the following conditions are met:
 - a. the deposit insurer is informed and involved in the resolution decision-making process;
 - b. the use of the deposit insurer's funds is transparent and documented, and is clearly and formally specified;
 - c. where an **Islamic bank** is resolved through a resolution process other than liquidation, the resolution results in a viable, solvent and restructured bank, which limits the exposure of the deposit insurer to contribute additional funding in respect of the same obligation;
 - d. contributions are restricted to the costs the deposit insurer would otherwise have incurred in a payout of insured depositors in a liquidation net of expected recoveries;
 - e. contributions are not used to recapitalise resolved institutions unless shareholders' interests are reduced to zero, and uninsured, unsecured creditors are subject to parri passu losses in accordance with the legal claim priority;

⁴¹ An appropriate basis may include actual costing, or allocation of expenditures based on the proportionate size of the income or size of the fund of the IDIF vis-à-vis CDIF. The deposit insurer's accounting and information technology (IT) systems should make it possible, ex-ante, to separate the expenditures to be charged under each of the funds (IDIF and CDIF.).

⁴² Such use may be compulsory under national law.

- f. the use of the deposit insurer’s funds is subject to an independent audit and the results are reported back to the deposit insurer; and
 - g. all resolution actions and decisions using the deposit insurer’s funds are subject to ex-post review.
11. Should deposit insurer income/revenue (e.g. **contributions** received, recoveries from failed **Islamic banks** and **profit** accrued on investment funds) be taxed by the government, it is at a rate that is neither punitive nor disproportionate to other corporate taxation, and does not unduly hinder the accumulation of the deposit insurance fund. Any remittances to the government by the deposit insurer are limited to repayment of government-provided start-up funding and government-provided liquidity funding.
12. If the deposit insurer uses differential **contributions**⁴³ within the Islamic banking system:⁴⁴
- a. the system for calculating **contributions** is transparent to all participating **Islamic banks**;
 - b. the scoring categories are significantly differentiated between Islamic banks;⁴⁵ and
 - c. the ratings and rankings resulting from the system pertaining to individual **Islamic banks** are kept confidential.

⁴³ The IADI CPs discuss a differential “premium” system. However, for an Islamic deposit insurance system (IDIIS), the term “premium” is not appropriate as in essence the Shari’ah arrangements and underlying contracts in the IDIS, are based on the concept of mutual welfare, and not that of a commercial exchange-based contract. In this arrangement, all member Islamic banks of the IDIS would participate to make committed donations (*Tabarru*) into a pool for helping any member Islamic bank which may run into insolvency / other issues requiring the Islamic deposit insurance fund (IDIF)’s support to reimburse depositors. Nonetheless, in all cases, regulatory requirements may in fact have the same effect for “contributions” in IDIS as is for “premiums” in CDIS, since membership of, and making “contributions” to the IDIF would be obligatory upon the Islamic banks. To that extent, the use of “contributions” as opposed to “premium” in the CPIDIS does not change the impact and underlying objectives.

⁴⁴ See IADI, *General Guidance for Developing Differential Premium Systems* (2011.).

⁴⁵ For Islamic banking windows, the deposit insurer may apply the scoring categories of their CDIS member banks or determine their scoring categories separately based on the differential contribution system for Islamic banks.

CPIDIS 10: PUBLIC AWARENESS

In order to protect depositors and contribute to financial stability, it is essential that the public be informed on an ongoing basis about the benefits and limitations of the **Islamic deposit insurance system**.

Essential criteria

1. The deposit insurer is responsible for promoting public awareness of **the Islamic deposit insurance system**, using a variety of communication tools on an ongoing basis as part of a comprehensive communication programme.
2. In the event of an **Islamic bank** failure, the deposit insurer must notify depositors, as appropriate and as described in law, via media such as press releases, print advertising, websites and other media outlets, of the following details:
 - a. where, how and when protected depositors will be provided with access to their funds;⁴⁶
 - b. the information that an insured depositor must provide in order to obtain payment;
 - c. if advance or interim payments are being made; and⁴⁷
 - d. whether any depositors will lose funds, and procedures whereby unprotected depositors can make claims to the liquidator for their unprotected portion.
3. The public awareness programme or activities convey information about the following:
 - a. the scope (i.e. which types of financial instruments and depositors and/or **investment accounts/IAHs** are covered by deposit insurance, and which are not);
 - b. a list of which **Islamic banks** are members and how they can be identified;
 - c. deposit insurance coverage level limits; and

⁴⁶ For example, whether an assuming/agent bank will assume deposits and reimburse or otherwise make them available, or whether reimbursement is provided through the failed bank's facilities.

⁴⁷ For example, in the case of unavoidable prolonged delays such as a "surprise" bank failure where there has been no opportunity for advance preparation.

- d. other information, such as the mandate of the deposit insurer and its **compliance with Shari'ah requirements**.
4. The objectives of the public awareness programme (e.g. target awareness levels) are clearly defined and consistent with the public policy objectives and mandate of the **Islamic deposit insurance system**.
5. The deposit insurer sets a long-term strategy to meet its public awareness objectives and makes budget allocations to build and maintain a target level of public awareness about deposit insurance.
6. The deposit insurer works closely with **Islamic banks** and other safety-net participants to ensure the consistency and accuracy of the information provided to depositors and to maximise awareness on an ongoing basis. Law or regulation requires **Islamic banks** to provide information about deposit insurance in a format/language prescribed by the deposit insurer.
7. The deposit insurer monitors, on an ongoing basis, its public awareness activities and arranges, on a periodic basis, independent evaluations of the effectiveness of its public awareness programme or activities.
8. Depositors in jurisdictions affected by cross-border banking arrangements conducted through foreign bank branches or subsidiaries are provided with clear information on the existence and identification of the deposit insurer legally responsible for reimbursement, and the limits and scope of coverage.

CPIDIS 11: LEGAL PROTECTION

The deposit insurer and individuals working both currently and formerly for the deposit insurer in the discharge of its mandate must be protected from liability arising from actions, claims, lawsuits or other proceedings for their decisions, actions or omissions taken in good faith in the normal course of their duties. Legal protection should be defined in legislation.

Essential criteria

1. Legal protection is specified in legislation and provided to the deposit insurer, its current and former directors, officers and employees, and any individual⁴⁸ (including, where applicable, Shari'ah advisors/Shari'ah board members) currently or previously retained or engaged by the deposit insurer, for decisions made and actions or omissions taken in good faith in the normal course of their duties.
2. Legal protection precludes damages or other awards against such individuals and covers costs, including funding defence costs as incurred (and not just reimbursement after a successful defence).
3. The operating policies and procedures of the deposit insurer require individuals with legal protection to disclose real or perceived conflicts of interest and to adhere to relevant codes of conduct, to ensure that they remain accountable.
4. Legal protections do not prevent depositors or other individual claimants or Islamic banks from making legitimate challenges to the acts or omissions of the deposit insurer in public or administrative review (e.g. civil action) procedures.

⁴⁸ A contractual indemnity in an individual's contract of employment or engagement with the deposit insurer and/or private insurance is not a substitute for legal protection defined in legislation or recognised in law.

CPIDIS 12: DEALING WITH PARTIES AT FAULT IN AN ISLAMIC BANK FAILURE

The deposit insurer, or other relevant authority, should be provided with the power to seek legal redress against those parties at fault in an **Islamic bank's** failure.

Essential criteria

1. The conduct of parties responsible for, or contributing to, the failure of an **Islamic bank** (e.g. officers, directors, managers, owners), as well as the conduct of related parties and professional service providers (e.g. auditors, accountants, lawyers and asset appraisers) is subject to investigation. **This includes parties tasked with ensuring Shari'ah compliance of an Islamic bank, including those responsible for Shari'ah governance.** The investigation of the conduct of such parties may be carried out by one or more of the following: the deposit insurer, supervisor or regulatory authority, criminal or investigative authorities, or any other professional or disciplinary body, as applicable.
2. The relevant authority takes the appropriate steps to pursue those parties that are identified as culpable for the failure of the **Islamic bank**. The culpable parties are subject to sanction and/or redress. Sanction or redress may include personal or professional disciplinary measures (including fines or penalties), criminal prosecution and civil proceedings for damages.
3. The deposit insurer, or other relevant authority, has policies and procedures in place to ensure that insiders, related parties and professional service providers acting for the failed Islamic bank are appropriately investigated for wrongdoing and for possible culpability in an **Islamic bank** failure.

CPIDIS 13: EARLY DETECTION AND TIMELY INTERVENTION

The deposit insurer should be part of a framework within the financial safety net that provides for the early detection of, and timely intervention in, troubled **Islamic banks**. The framework should provide for intervention before the **Islamic bank** becomes non-viable. Such actions should protect depositors and contribute to financial stability.

Essential criteria

1. The deposit insurer is part of an effective framework within the financial safety net that provides for the early detection of, and timely intervention in, **Islamic banks** in financial difficulty before the bank becomes non-viable.⁴⁹
2. Safety-net participants have the operational independence and power to perform their respective roles in the framework for early detection and timely intervention.
3. The framework includes a set of clearly defined qualitative and/or quantitative criteria that are used to trigger timely intervention or corrective action. The criteria:
 - a. are clearly defined in law, regulation or agreements;
 - b. include safety and soundness indicators such as the institution's capital, asset quality, **management, earnings, liquidity, sensitivity to market risk and other risks**⁵⁰ **specific to Islamic banks; and**
 - c. are reviewed periodically, and the procedure for this review is formalised.

⁴⁹ The degree of implementation and effectiveness of an early detection and timely intervention framework is determined through an assessment of the IFSB's *Banking Core Principles*, the *Basel Core Principles for Banking Supervision* (BCPs) and *Key Attributes of Effective Resolution Regimes* (KAs) where applicable.

⁵⁰ See IFSB-1 *Guiding Principles of Risk Management for Institutions (other than Insurance Institutions) offering only Islamic Financial Services (IIFS)*

CPIDIS 14: FAILURE RESOLUTION

An effective failure-resolution regime should enable the deposit insurer to provide for protection of depositors and contribute to financial stability. The legal framework should include a special resolution regime.

Essential criteria

1. The deposit insurer has the operational independence and sufficient resources to exercise its resolution⁵¹ powers consistent with its mandate.
2. The resolution regime ensures that all Islamic banks are resolvable through a broad range of powers and options. **These options are consistent with the Shari'ah framework as applied in the jurisdiction.**
3. Where there are multiple safety-net participants responsible for resolution, the legal framework provides for a clear allocation of objectives, mandates and powers of those participants, with no material gaps, overlaps or inconsistencies. Clear arrangements for coordination are in place.
4. Resolution and depositor protection procedures are not limited to depositor reimbursement. The resolution authority/ies has/have effective resolution tools designed to help preserve critical **Islamic bank** functions and to resolve banks. These include, but are not limited to, powers to replace and remove senior management, **(subject to compliance with Shari'ah rules) transfer and sell assets and liabilities,** convert debt to equity and/or establish a temporary bridge institution.
5. One or more of the available resolution methods allows the flexibility for resolution at a lesser cost than otherwise expected in a liquidation net of recoveries.

⁵¹ In this document, "resolution" refers to the disposition plan and process for a non-viable Islamic bank. Resolution may include the liquidation and reimbursement of insured deposits, and (subject to compliance with the Shari'ah requirements) the transfer and/or sale of assets and liabilities, the establishment of temporary bridge institutions, and the write-down and/or conversion of debt to equity of the non-viable Islamic bank. Resolution may also include the application of procedures under insolvency law to parts of a firm in resolution, in conjunction with the exercise of resolution powers.

6. **Subject to compliance with the Shari'ah framework as applied in the jurisdiction,** resolution procedures follow a defined creditor hierarchy in which protected deposits are protected from sharing losses and shareholders take first losses.
7. The resolution regime does not discriminate against depositors on the basis of their nationality or residence.
8. The resolution regime is insulated against legal action that aims at the reversal of decisions related to the resolution of non-viable Islamic banks. No court can reverse such decisions. The legal remedy for successful challenges is limited to monetary compensation.
9. The resolution regime keeps the period between depositors losing access to their funds and implementation of the selected resolution option (e.g. depositor reimbursement) as short as possible.

CPIDIS 15: REIMBURSING DEPOSITORS

The **Islamic deposit insurance system** should reimburse depositors' insured funds promptly, in order to contribute to financial stability. There should be a clear and unequivocal trigger for insured depositor reimbursement.

Essential criteria

1. The deposit insurer is able to reimburse most⁵² insured depositors within seven working days. If the deposit insurer cannot currently meet this target, the deposit insurer has a credible plan in place to do so.
2. To be credible, the reimbursement plan:
 - a. has a clear time frame for implementation (e.g. within two years);
 - b. is supported by relevant laws, regulations, systems and processes (e.g. intervention and resolution manuals); and
 - c. has clear and measurable deliverables.
3. In situations where reimbursement is triggered and there may be extended delays in reimbursements, the deposit insurer may make advance, interim or emergency partial payments.
4. To provide depositors with prompt access to their funds, the deposit insurer:
 - a. has access to depositors' records at all times, which includes the authority to require Islamic banks to maintain depositor information in a format prescribed by the deposit insurer to expedite protected depositor reimbursement;
 - b. has the authority to undertake advance or preparatory examinations (e.g. on-site and independently or in conjunction with the supervisory authority) on the

⁵² The term "most" is used to recognise that there may be some types of deposits which would be operationally difficult to reimburse within seven working days, such as trust accounts with multiple beneficiaries.

reliability of depositor records, and has tested member institution's IT systems and data to ensure the capability to produce such records; and

- c. has a range of reimbursement options.⁵³
5. The deposit insurer has the capacity and capability to promptly carry out the reimbursement process, including:
 - a. adequate resources and trained personnel (in-house or contractors) dedicated to the reimbursement function and supported with reimbursement manuals;
 - b. information systems to process depositor information in a systematic and accurate manner;
 - c. pre- and post-closing activities specified in closing documentation or manuals; and
 - d. scenario planning and simulations, including simulations on Islamic bank closings with supervisory and resolution authorities.
6. A review (e.g. post mortem) following an **Islamic bank** failure is performed to determine and analyse elements of the reimbursement process (including the resolution procedures where applicable) that were successful or unsuccessful.
7. An independent party conducts a periodic audit of the reimbursement process to confirm that appropriate internal controls are in place.
8. If set-off of insured deposits against past-due claims (e.g. repayment obligations and arrears) or matured financing is applied, such application is timely and does not delay prompt reimbursement of protected depositors' claims or undermine financial stability.
9. Working arrangements and/or agreements are in place with relevant clearing and settlement system agencies and liquidators to ensure that transit items are dealt with in an appropriate, consistent and timely manner.⁵⁴

⁵³ These may include cheque payments, electronic transfers, payment agents, cash payments, and the transfer of deposits through closed-bank purchase and assumption (P&A) transactions.

10. In cases where the deposit insurer does not have the authority to act as a liquidator, the liquidator is obliged by law or regulation to cooperate with the deposit insurer to facilitate the reimbursement process.

⁵⁴ For more extensive guidance on ensuring prompt reimbursement, see IADI, *Enhanced Guidance for Effective Deposit Insurance Systems: Reimbursement Systems and Practices* (2013.).

CPIDIS 16: RECOVERIES

The deposit insurer should have, by law, the right to recover its claims including **claims of the Islamic deposit insurance fund under its management**,⁵⁵ in accordance with the statutory creditor hierarchy.

Essential criteria

1. The deposit insurer's role in the recovery process is clearly defined in law. The deposit insurer **or the Islamic deposit insurance fund** is clearly recognised as a creditor of the failed **Islamic bank** by subrogation.
2. The deposit insurer **or Islamic deposit insurance fund** has at least the same creditor rights or status as a depositor in the treatment in law of the estate of the failed **Islamic bank**.
3. The deposit insurer, in its capacity as a creditor, **or the Islamic deposit insurance fund** has the right of access to information from the liquidator so that it can monitor the liquidation process.
4. The management and disposition of the assets of a failed **Islamic bank** in its asset management and recovery approaches are guided by commercial and economic considerations.
5. Those working on behalf of the deposit insurer, other financial safety-net participants and third-party professional service providers providing resolution services are not permitted to purchase assets from the liquidator.

⁵⁵ IDIS can be implemented under different Shari'ah arrangements. The different arrangements give rise to, among other things, different ownership status of the fund; that is, the fund is owned by the deposit insurer (*kafalah* arrangement)), or the fund is not owned but is managed by the deposit insurer (*takaful* arrangement).

CPIDIS 17: SHARI'AH GOVERNANCE

The Islamic deposit insurance system should have in place a comprehensive and properly functioning Shari'ah governance⁵⁶ system.

Essential criteria

1. The Islamic deposit insurance system has an adequate Shari'ah governance system to ensure its design, procedures and operations are in compliance with Shari'ah principles, along with ongoing monitoring mechanisms to ensure the system's continued compliance.
2. The Shari'ah governance system (e.g. in the form of a Shari'ah board):⁵⁷
 - a. has appropriate knowledge, skills, competence and expertise;
 - b. acts in an independent and transparent manner, and any potential conflicts of interest are appropriately managed;
 - c. is adequately resourced and serviced to carry out its duties diligently; and
 - d. abides by codes of ethics and confidentiality to ensure that internal information obtained in the course of its duties is kept confidential.
3. The Islamic deposit insurance system enables the Shari'ah governance body to conduct its activities in an independent manner and facilitates the process of effective deliberations and Shari'ah pronouncements on operational matters of the system.
4. The Islamic deposit insurance system provides adequate information and disclosures to stakeholders (including board of directors as well as the general public) as to how Shari'ah governance is being practised by the organisation.

⁵⁶ See IFSB-10: *Guiding Principles on Shari'ah Governance Systems*. See also IADI Discussion Paper, "Shari'ah Governance for IDIS" (February 2018).

⁵⁷ For IDIS, the Shari'ah governance system may include (i) an embedded Shari'ah board within the entity (i.e. IDIS); or (ii) a centralised board outside the IDIS that has recognised authority over matters of Islamic finance (e.g. Shari'ah board of the central bank). When the first two options are not available to an IDIS due to specific country circumstances (e.g. the secular law of the land), the IDIS may appoint an external Shari'ah advisory firm for oversight of its operations, products and services for Shari'ah compliance. This external Shari'ah advisory firm must comply with the various criteria as established in CPIDIS 17, Essential Criterion Criteria 2.

Annex 1: Assessment of Compliance with the CPIDIS

This annex presents guidance and a format for compliance assessment and the structure of the assessment reports.⁵⁸

Compliance Assessment

The primary objective of an assessment should be to evaluate compliance with the CPIDIS after taking into account the structural, legal and institutional features of each national deposit insurance system. The assessment should review the functions inherent in providing effective IDIS, as opposed to an assessment of just the deposit insurer. In so doing, the assessment will identify the strength(s) of the IDIS, and the nature and extent of any weaknesses. Importantly, the assessment is a means to an end, not an objective in itself. The assessment process should help the deposit insurer and policymakers benchmark their IDIS against the CPIDIS to judge how well the system is meeting its public policy objectives. The assessment, in turn, can also aid the deposit insurer and policymakers in making improvements to the IDIS and financial safety net, as necessary.

The methodology proposes a set of essential criteria for each CPIDIS. The essential criteria are the only elements on which to gauge full compliance with the CPIDIS. Assessments by external parties follow a five-grade scale as follows:⁵⁹

- **Compliant:** When the essential criteria are met without any significant deficiencies.⁶⁰
- **Largely compliant:** When only minor shortcomings are observed and the authorities are able to achieve full compliance within a prescribed time frame.
- **Materially non-compliant:** Severe shortcomings which cannot be rectified easily.

⁵⁸ This format was recommended by the IMF and the World Bank for use by assessors in the context of Financial Sector Assessment Program (FSAP) or Offshore Financial Center Program (OFC) missions. In order to maintain comparability and consistency, the format was also recommended for stand-alone assessments or self-assessments by a jurisdiction. See *Core Principles for Effective Banking Supervision* (2012.).

⁵⁹ This scale is used for external assessments in the IFSB's Banking Core Principles and the Basel Committee's Core Principles Methodology (Banking Supervision), available at www.bis.org/publ/bcbs130.htm.

⁶⁰ In order to achieve a "Compliant" grade, it is not always necessary to achieve compliance on all essential criteria for each CPIDIS. For example, if an IDIS is compliant with eight out of nine essential criteria for a specific CPIDIS but is not compliant in a relatively minor area, then the overall compliance rating could be designated "Compliant". Assessors must exercise judgment in these situations.

- **Non-compliant:** No substantive implementation of the CPIDIS.
- **Not applicable:** Not considered given the structural, legal and institutional features of the deposit insurance system.

Grading is not an exact science and the CPIDIS can be met in different ways. The assessment criteria should not be seen as a checklist approach to compliance, but as a qualitative exercise. The number of criteria in compliance, and the commentary that should accompany each criterion, will be weighed in the scoring process for each CPIDIS. However, not all criteria will carry equal weight. It is critical for the assessors to receive training on the consistent application of the methodology. The CPIDIS are benchmarks for effective deposit insurance practice. In implementing them, deposit insurers and policymakers will need to take into account jurisdiction-specific factors.

Assessors should pay close attention to the adequacy of the operating environment and include their opinion on gaps and weaknesses in the environment and actions that policymakers could take to mitigate those weaknesses. The assessment of compliance with individual CPIDIS could flag those Islamic core principles that are likely to be primarily affected by external conditions considered to be weak, after factoring in specific jurisdiction circumstances, mandate and structures of the deposit insurance system. However, assessors should not undertake to assess compliance with the operating environment themselves. Instead, wherever possible, assessors should rely on the results of recent IMF/World Bank FSAP reports and, where relevant, FSB peer reviews. If a report has not been conducted recently, assessors should request from the authorities that they are provided with updates on any changes since the previous FSAP report. If no such reports on preconditions are available, assessors should assign an “Insufficient Information” rating to the operating environment review. Recommendations with regard to the operating environment should not be part of the action plan associated with the CPIDIS assessment but should be included in other general recommendations for strengthening the deposit insurance system.

In order to assist assessors in interpreting the methodology and identifying CPIDIS that may or may not be applicable in all types of arrangements of IDIS, a *Handbook Guide for Assessors of CPIDIS* will be developed.⁶¹ This document includes supporting guidance to assist assessors in

⁶¹ IADI and IFSB will jointly develop this handbook in due course following release of the final set of CPIDIS.

applying the criteria to specific jurisdictional settings and structures. The handbook will be updated over time to take into account the experiences and lessons learned in conducting compliance assessments.

Use of the Methodology

The methodology can be used in multiple contexts: (i) self-assessment performed by the deposit insurer; (ii) IMF and World Bank assessments of the quality of deposit insurance systems – for example, in the context of the FSAP or Technical Assistance (TA) projects; (iii) peer reviews conducted, for example, within IADI regional committees or through the FSB peer review process; and (iv) reviews conducted by private third parties such as consulting firms. Both **IADI and IFSB** will be active in interpreting **the CPIDIS** and providing training; this includes guidance on best practices during the assessment process.

Whether conducted by a deposit insurer (self-assessment) or an outside party, a fully objective assessment of compliance with the **CPIDIS** should be performed by suitably qualified parties who bring varied perspectives to the process. It is beneficial that the parties be made up of suitably qualified persons, including individuals with experience of working **in an IDIS and dealing with Islamic bank failures**. A fair assessment of the **IDIS** also requires the cooperation of all relevant authorities. The process of assessing each of the **17 CPIDIS** requires a judgmental weighting of numerous elements that only qualified assessors with practical, relevant experience can provide. To the extent that the assessment requires legal and accounting expertise in the interpretation of compliance with the **CPIDIS**, these legal and accounting interpretations must be in relation to the legislative and accounting structure of the relevant jurisdiction. The assessment must be comprehensive and in sufficient depth to allow a judgment on whether criteria are fulfilled in practice, not just in theory. Similarly, laws and regulations need to be sufficient in scope and depth. There must also be effective enforcement of and compliance with those laws and regulations on the part of regulators, supervisors and the deposit insurer. Finally, the assessment of compliance with the CPIDIS will build upon any recent work in similar areas such as the FSAPs.

Assessment Report

The assessment report should include the following:

- A general section that provides background information on the assessment conducted, including information on the organisation being assessed and the context in which the assessment is being conducted.
- A section on the information and methodology used for the assessment.
- An overview of the institutional and macroeconomic setting and market structure.
- A review of the operating environment, including Shariah compliance mechanism/Shariah governance framework for effective IDIS.
- A compliance table, summarising the assessment results (Table 1);
- A recommended action plan (including Shari’ah-compliant resolution and contingency planning) providing principle-by-principle recommendations for actions and measures to improve the IDIS and practices (Table 2).
- A detailed principle-by-principle assessment, describing the system with reference to a particular principle, a grading or “assessment”, and a “comments” section (Table 3).
- A section for authorities’ comments (including Shari’ah authority’s opinion/ruling on the overall Shari’ah compliance environment of the IDIS).

Compliance Assessment and Summary Tables

Table 1
Summary of Compliance with the IADI-IFSB Core Principles for Effective IDIS Detailed Assessments

| Core Principle | Grade | Comments |
|--------------------------|---|----------|
| Reference CPIDIS 1 | C, LC, MNC, NC, NA ⁶² | |
| Repeat for all 17 CPIDIS | C, LC, MNC, NC, NA | |

Table 2
Recommended Action Plan to Improve Compliance with the IADI-IFSB Core Principles for Effective IDIS

| Reference Principle | Recommended Action |
|---|---|
| CPIDIS 1 | Description of deficiency Suggested course of action |
| CPIDIS 2 | Description of deficiency Suggested course of action |
| Repeat for all CPIDIS with a recommended action | Description of deficiency Suggested course of action |

⁶² Compliant (C), Largely Compliant (LC), Materially Non-Compliant (MNC), Non-Compliant (NC), Not Applicable (NA).

| Table 3 | |
|---|----------------------------------|
| Core Principles for Effective IDIS Detailed Assessment Table | |
| CPIDIS 1: (repeat verbatim text of CPIDIS 1) | |
| Description | |
| Assessment | C, LC, MNC, NC, NA |
| Comments | |
| For each Essential Criterion: | |
| Description | |
| Assessment | C, LC, MNC, NC, NA ⁶³ |
| Comments | |
| Repeating for all 17 CPIDIS | |
| | |

Practical Considerations in Conducting a Compliance Assessment

In addition to the format for conducting a compliance assessment, the following practical considerations should be taken into account:

1. The assessor should have access to a range of information and interested parties. This may include published information, more sensitive information (i.e. previously completed self-assessments, information on the health of insured institutions such as supervisory examination results), and operational guidelines for the deposit insurer. This information should be provided as long as it does not violate legal requirements for the deposit insurer to hold such information confidential. The assessor should also meet with a range of individuals and organisations, including other financial safety-net participants and relevant government ministries, commercial bankers and auditors.

⁶³ It is recommended that each essential criterion be graded by the assessor. However, the assessment grade for each essential criterion should not be included in the FSAP's final *Reports on the Observance of Standards and Codes* (ROSC) provided to authorities.

Special note should be made of instances when any required information is not provided, as well as of what effect this might have on the accuracy of the assessment.

Assessors should set out the range of information required from the authorities involved and, at the initial meeting with the individuals involved, explain how the assessment will proceed. This should include the process to be followed in the assessment for the review of the operating environment.

2. The assessment of compliance with each CPIDIS requires the evaluation of a chain of related requirements, such as laws, prudential regulation and supervisory guidelines including instructions related to Shari'ah compliance. The assessment must ensure that the requirements are or can be put into practice. For example, policymakers must ensure that the deposit insurer has the necessary operational independence, skills and resources to fulfil its public policy objectives.
3. In addition to identifying deficiencies, the assessment should also highlight positive features and key achievements.
4. Cooperation and information sharing among safety-net participants is necessary for the effectiveness of the deposit insurance system. The assessor should be able to judge whether such information sharing occurs. Depending on the materiality of cross-border banking, it is also important that the assessor is able to judge whether information sharing occurs between deposit insurers and other safety-net participants in different jurisdictions.

Annex 2: Key Considerations for Investment Accounts under IDIS

1. The deposit insurer may protect investment accounts under IDIS if such protection contributes to financial stability and if it is consistent with IDIS public policy objectives. This view can be formed based on, among other things, the following reasons:
 - a. There is evidence that the IAHS have behaved, or will potentially behave, similarly to depositors, either as a reaction to poor performance of underlying assets or a bank's (*mudarib*) negligence, or in an idiosyncratic or system-wide crisis situation (i.e. displaced commercial risks).
 - b. The size of investment accounts in the IFSI is material such that an explicit protection intends to promote the confidence of IAHS.
 - c. Investment accounts are treated as deposits by regulators due to prevailing legal framework provisions through, among other things, priority of claims in the legal framework of the jurisdiction, capital treatment, liquidity requirement, product classification or accounting treatment, and product disclosure. This treatment will lead to an investment account posing risks similar to those of depositors.
2. Apart from the objective of contributing to financial stability, the deposit insurer may set additional objectives for the protection of investment accounts provided that they do not conflict with the overall financial stability objective. For instance, the deposit insurer may decide to:
 - a. provide protection to the Islamic banks' customers equal to that accorded to the customers of conventional banks;
 - b. avoid regulatory arbitrage and preserve the competitiveness of the Islamic banks' products.
3. The deposit insurer excludes a restricted investment account from IDIS coverage if it is not detrimental to financial stability.

4. All principles and essential criteria set out in the CPIDIS that concern the protection of deposits under IDIS are also applicable to the protection of investment accounts. Nonetheless, the exceptions and additional considerations are as follows:

- *Coverage*

- a. The level of coverage for unrestricted investment accounts is set such that it promotes the confidence of insured IAHS, regardless of whether the coverage level is at par with or different from the coverage level for deposits.
- b. The protected amount of investment accounts is the outstanding balance in the winding-up, in which the sum may be lower, or higher, than the original principal placed by IAHS due to investment losses prior to the winding-up. This is to maintain the loss-bearing nature of such product.

- *Sources and Uses of the Fund*

- a. The party responsible for funding the protection of investment accounts under IDIS is subject to the views of each jurisdiction's Shari'ah governance system.⁶⁴
- b. Where the protection for investment accounts is not funded by Islamic banks, the deposit insurer considers the following:
 - i. Moral hazard, in that an Islamic bank is motivated to assume greater risks when investing IAHS' funds, since it does not bear the IDIS costs, particularly in the absence of a robust regulatory and supervisory framework. If there is evidence of moral hazard, the deposit insurer implements measures to mitigate such incidence.
 - ii. Effective provision of incentives to Islamic banks for sound risk management practices through a differential or risk-based contributions system. For example,

⁶⁴ The views of Shari'ah scholars differ as to who should be the responsible party to fund the protection of investment accounts under IDIS. Based on the practices of the jurisdictions that have implemented IDIS, a few require IAHS to make contribution payments, while the remaining jurisdictions require Islamic banks to do so.

if the high-risk profile of an Islamic bank is translated into higher contributions payable by other parties, there is no incentive for an Islamic bank to improve its risk profile.

- c. Where the protection for investment accounts is funded by IAHS (from investment profits), the deposit insurer considers the following:
 - i. the Shari'ah board's views on whether the contributions can be commingled with, or maintained separately from, contributions paid by the Islamic bank for the protection of deposits;
 - ii. if the contributions are maintained separately, the need for the deposit insurer to prepare separate records for the investment accounts protection fund and deposits protection fund;
 - iii. effective implementation of a target fund framework, especially when the time frame to achieve the target fund size requires an increment in the contribution rate to be imposed on IAHS; and
 - iv. where the objective of the protection for investment accounts is to promote the growth of such a product, the need for the deposit insurer to assess whether such funding structure is costly to IAHS and hinders achievement of the objective.
- *Public Awareness*
 - a. A public awareness programme must include information about whether or not investment accounts are covered by IDIS.
- *Failure Resolution*
 - a. Where investment accounts are managed in a pool with Islamic banks' funds, the deposit insurer formally and clearly specifies in the legislation the hierarchy for reimbursement of IAHS in the event of a winding-up.

- b. In the winding-up, where investment accounts are managed separately from Islamic banks' funds and the assets funded by such accounts are properly tagged or ring-fenced, the deposit insurer segregates the disposal proceeds of such assets from the assets of Islamic banks. The deposit insurer formally and clearly specifies in the legislation the allocation of such proceeds to IAHs. For instance, if there are certain costs to be deducted prior to allocating the residual proceeds to IAHs, the costs are specified.
- c. In the winding-up, the deposit insurer distributes any outstanding share of profit equalisation reserve (PER) to the IAH and the Islamic bank, as well as distribute any outstanding investment risk reserve (IRR) to the IAH based on the method determined by the banking regulator.

- *Recoveries*

- a. Where the investment accounts protection fund is a separate legal and financial entity, the fund is treated as follows:
 - i. it is clearly recognised as a creditor of the failed Islamic bank by subrogation; and
 - ii the fund has at least the same creditor rights or status as an IAH by law in the treatment of the assets funded by the IAH.
- b. The management and disposition of the assets funded by investment accounts in Islamic banks' are guided by commercial and economic considerations.

Appendix A: Mapping the IADI CPs: The CPIDIS Approach

| IADI Core Principles | CPIDIS Approach: Revised CPs in the Form of CPIDIS Reflecting the Specificities of Islamic Banks |
|--|--|
| CP 1: Public Policy Objectives | CPIDIS 1 – Amended <ul style="list-style-type: none"> • Modified the main principle • Modified two ECs |
| CP 2: Mandate and Powers | CPIDIS 2 – Amended <ul style="list-style-type: none"> • Modified one EC |
| CP 3: Governance | CPIDIS 3 – Retained unamended |
| CP 4: Relationships With Other Safety-Net Participants | CPIDIS 4 – Retained unamended |
| CP 5: Cross-Border Issues | CPIDIS 5 – Amended <ul style="list-style-type: none"> • Introduced one new EC |
| CP 6: Deposit Insurer’s Role in Contingency Planning and Crisis Management | CPIDIS 6 – Amended Introduced one new EC |
| CP 7: Membership | CPIDIS 7 – Amended <ul style="list-style-type: none"> • Modified one EC |
| CP 8: Coverage | CPIDIS 8 – Amended <ul style="list-style-type: none"> • Introduced one new EC • Modified one EC |
| CP 9: Sources and Uses of Funds | CPIDIS 9 – Amended <ul style="list-style-type: none"> • Introduced one new EC • Modified six ECs |
| CP 10: Public Awareness | CPIDIS 10 – Amended <ul style="list-style-type: none"> • Modified one EC |
| CP 11: Legal Protection | CPIDIS 11 – Amended <ul style="list-style-type: none"> • Modified one EC |
| CP 12: Dealing With Parties at Fault in an Islamic Bank Failure | CPIDIS 12 – Amended <ul style="list-style-type: none"> • Modified one EC |
| CP 13: Early Detection and Timely Intervention | CPIDIS 13 – Amended <ul style="list-style-type: none"> • Modified one EC |
| CP 14: Failure Resolution | CPIDIS 14 – Amended <ul style="list-style-type: none"> • Modified three ECs |
| CP 15: Reimbursing Depositors | CPIDIS 15 – Retained unamended |
| CP 16: Recoveries | CPIDIS 16 – Amended <ul style="list-style-type: none"> • Modified the main principle • Modified three ECs |
| Additional Core Principles | |
| Shari`ah Governance | New: CPIDIS 17 |

Note: EC = Essential Criteria

Appendix B: Specificities of IDIS

The Uniqueness of Islamic Banking

Islamic and conventional banks share a common financial intermediary role. What differentiates them is the requirement for the former to comply with Shari'ah principles. Shari'ah principles include the prohibition of interest-based (*riba*) transactions, excessive uncertainty (*gharar*), speculation (*qimar*) and gambling (*maysir*), and the promotion of risk sharing, ethical banking, social justice and fairness. These principles define the uniqueness of Islamic banking operations, which are reflected in their institutional set-up, the products and services they offer (including the purpose of offering these products and services), and the different types of relationships between the banks and their customers. Conventional banks, on the other hand, structure their assets and liabilities mainly on a debt-based contract basis.

On the asset side, financing contracts include the sales at profit margin and deferred payments (*murabahah*), lease-based financing (*ijarah*), manufacturing or construction financing contracts (*istisna*) and the forward sale of fungible goods for immediate payment (*salam*).

For partnership arrangements, the Islamic banks provide financing through a joint partnership with customers for a specific economic activity based on a pre-specified profit-and-loss sharing arrangement. The contracts include the profit and loss bearing by the capital provider (*mudarabah*) and the profit-and-loss-sharing (*musharakah*) contracts. Another form of transaction is a fee-based arrangement, which includes the contract of *wakalah* and service fees (*ujr*).

On the liability side, the funding structure of the Islamic banks can be categorised into principal guaranteed deposit contracts (e.g. *qard*-based accounts) and non-principal guaranteed deposits (investment accounts⁶⁵). Unlike conventional banks that operate on the basis of borrowing and lending with pre-specified interest rates, deposit contracts for demand and current accounts do not attract interest rate; and for investment accounts, the IAHs receive returns that are

⁶⁵ "Investment account" refers to a funding product where Islamic banks accept these funds for investment purposes. The contracts normally used for this account are profit and loss sharing (*musharakah*), profit sharing and loss bearing (*mudarabah*), and agency (*wakalah*). There are two forms of investment accounts: restricted and unrestricted accounts. In various jurisdictions, investment accounts are treated either as a liability, a partial liability or an investment product, depending on the prevailing legal framework.

determined ex-post, based on the returns generated by the underlying assets funded by their funds.

Due to the uniqueness of their balance sheets, Islamic banks face other risks in addition to the common ones inherent in conventional banking. Among the unique risks are Shari'ah non-compliance risk, displaced commercial risk and equity investment risk.

The Islamic window structure provides an avenue for a conventional bank to offer Islamic finance services. The window may be a branch or a dedicated unit of a conventional bank. The window is not separately incorporated, but both its assets and liabilities are required to be segregated from conventional business. This structure requires the bank to establish appropriate firewalls to avoid commingling of Islamic and conventional funds. The treatment of windows differs from one jurisdiction to another, depending on the legal and regulatory framework.

Shari'ah Requirements and Specificities for IDIS Design

The objective of implementing an IDIS is consistent with the objective of Shari'ah, which is to protect wealth. The attainment of such an objective requires the IDIS to be Shari'ah-compliant.

The operations of an IDIS are different from a CDIS in the following ways:

1. *Arrangement for Deposit Insurance*

The implementation of IDIS must be based on certain types of Shari'ah arrangements. Currently, the arrangements adopted are based on the *takaful* (mutual guarantee) and *kafalah* (guarantee) concepts. Other arrangements may also be adopted in consultation with or based on advice from Shari'ah scholars.

The application of different Shari'ah arrangements may result in different operational features. For instance, under the *takaful* approach, funding for deposit insurance is provided through donations by the Islamic banks and other parties. The fund is not owned by the IDIS, which acts as a fund manager, but is owned collectively by the fund contributors or by the fund itself (if it has a separate legal or financial status). In contrast, under the *kafalah*

approach, funding is paid by each Islamic bank for the deposit insurer's guarantee and the fund is owned by the deposit insurer.

2. Shari'ah Governance

The level of compliance with Shari'ah principles would depend on the institutional set-up. A full-fledged IDIS, where conventional banking is prohibited, needs to have in place a comprehensive Shari'ah governance framework to govern its business and operations.

However, for a deposit insurer administering both the IDIS and CDIS, the implementation of Shari'ah principles to the IDIS operations is limited to the following areas: the sources and uses of funds, the resolution of a failed Islamic bank, and the reimbursement of depositors/IAHs. Shari'ah laws do not apply to the operations of a CDIS. The list is presented in Table 1.

Table 1: Operational Aspects that are Subject to Shari'ah Governance

| Operational Aspects | Full-fledged IDIS | Integrated DI | |
|--|-------------------|---------------|------|
| | | IDIS | CDIS |
| <i>Sources and uses of funds</i> | | | |
| (i) Contributions received from the Islamic bank are maintained separately in IDIF. | Yes | Yes | No |
| (ii) Only permissible expenditures are charged to IDIF. | Yes | Yes | No |
| (iii) Investments are made in Shari'ah-compliant instruments. | Yes | Yes | No |
| (iv) Investment returns that are generated from non-Shari'ah-compliant instruments are treated appropriately based on the Shari'ah scholar's rulings – for example, distributions to charitable bodies. | Yes | Yes | No |
| (v) Sources of external funds (if any) are Shari'ah-compliant. For instance, if the deposit insurer borrows from the government, the agreement between the deposit insurer and the government does not contain an interest (<i>riba</i>) | Yes | Yes | No |

| Operational Aspects | Full- | Integrated DI | |
|--|----------------|----------------|--------------|
| element. | | | |
| <i>Failure resolution</i> Resolutions of a failed Islamic bank take into account unique characteristics of the institution and retain the Shari'ah-compliant status of the business. | Yes | Yes | No |
| <i>Reimbursing depositors</i> Payments to insured depositors and IAHS are made from IDIF. Priority of payments to the depositors and IAHS, whether the IAHS are ranked pari passu or below depositors. | Yes Yes | Yes Yes | No No |

3. *Islamic Banking Windows*

The deposits accepted by an Islamic banking window of a conventional bank that is a member of the CDIS should be covered under the IDIS, and not the CDIS. Appropriately, the window should be deemed as a member of the IDIS and should therefore be required to contribute to the IDIF (similar to the Islamic bank). Nonetheless, the guidelines in this CPIDIS account for various jurisdictional arrangements as discussed in CPIDIS 7, Essential Criterion 1; subsection 1.4.1.

4. *Investment Accounts*

Investment accounts, a non-principal guaranteed product, are unique to Islamic banking. If the account is a significant source of funding for an Islamic bank, the deposit insurer may cover this account for the purpose of financial stability. The coverage of investment accounts may influence the design features of the IDIS with respect to, among other things, funding for such coverage, maintenance of the fund, and the priority of payments in the winding up of a failed Islamic bank.

5. *The Management and Usage of an Islamic Deposit Insurance Fund*

The IDIF must be invested in Shari'ah-compliant instruments and its usage must be for permissible expenditures. In the event of an Islamic bank failure, the fund will be used to reimburse the failed bank's insured depositors or to carry out other resolution options.

Where a deposit insurer administers both the IDIS and CDIS, the IDIF must be maintained and managed separately from the conventional deposit insurance fund (CDIF) in compliance with Shari'ah requirements. Subject to the advice of the Shari'ah governance function, where the IDIF is deficient when carrying out a resolution, the deposit insurer may finance such deficiency through borrowings from the CDIF or any other sources, provided the mechanism in all circumstances is Shari'ah-compliant.

6. *Resolution of Failed Islamic Banks*

For deposit insurers with the mandate to resolve failed Islamic banks, the resolution mechanisms may differ from those used to resolve a conventional bank, depending on the advice from the Shari'ah board and applicable international standards and guidelines for Islamic banks.

Certain resolution options may also be conducted differently for certain types of Islamic products. One example relates to the priority of payments for investment accounts when winding up a failed Islamic bank.