

**DEPOSIT INSURANCE IN MALAYSIA: SHARIAH PERSPECTIVE
AND MUSLIMS ACKNOWLEDGMENT**

Nor Haziah Hashim

Syahidawati Shahwan

Universiti Sains Islam Malaysia

ABSTRACT

Deposit insurance is an insurance system established by policy makers in many countries to protect depositors against the loss of their deposits which are placed in bank(s) in the event of a 'run' on a bank. The United States was the first country to establish an official deposit insurance scheme during the Great Depression banking crisis in 1934, during which large number of customers of a bank withdrew their deposits because they feared it might become insolvent. In Malaysia, the system was launched on September 2005, and administered by the Malaysia Deposit Insurance Corporation (MDIC). This article will discuss the concept and historical aspect of deposit insurance and also the operation of Malaysia Deposit Insurance Corporation (MDIC). In addition to that, this article also discusses the Shariah perspective on this measure. A short survey was also administered to determine the public awareness and understanding of the scheme.

Keywords: Deposit insurance, Shariah perspectives and MDIC

Introduction

The purpose of deposit insurance may be different from one country to another. In most cases the measure are designed to protect depositors against the loss of their deposits placed in banks should the bank fail. It is also to ensure financial stability in the environment where banks are allowed to lend or use the money deposited instead of safe-keeping the full amounts. The United States was the first country to establish an official deposit insurance scheme, due to America's Great Depression banking crisis in the 1930s. During the time, a financial panic occurred when a large number of customers of a bank withdraw their deposits because they feared the bank might become insolvent. These actions leads to a situation called a 'run' on a bank.

A 'bank run' is a type of financial crisis that could destabilize the bank to the point where it becomes insolvent. To further explain why bank run occurs, an influential model of bank runs and related financial crisis was developed by Diamond and Dybvig (1983). The model shows how bank's mix of illiquid assets (long maturity assets) such as business or mortgage loans and liquid liabilities (short-term liabilities) such as deposits may cause financial instability. The model regards banks as intermediaries between the savers who prefer to deposit in liquid accounts and borrowers who prefer to take out long-maturity loans. Since banks provide a valuable service to both sides, they can charge a higher interest rate on loans than they pay on deposits and thus gaining profit from the difference.

According to Diamond-Dybvig model, this arrangement works well if there are only a few depositors withdraw their savings at one time. The bank expects only a small fraction of withdrawals in the short term even though all depositors have the right to take their deposits at any time. Thus, a bank can make loans over a long period, while keeping only a small fraction of their deposits as cash to pay any depositors who wish to make withdrawals. But if large numbers of withdrawals at one time are made, a different outcome is possible. The bank will be forced to call in their loans early and since the loans were used to finance long term investments, borrowers would be unable to pay back quickly. Therefore, if all depositors attempt to withdraw their funds simultaneously, a bank will run out of money before paying to all the depositors and ultimately will go bankrupt.

By having a measure such as the deposit insurance scheme, savers' deposits (up to a certain limit) in banks are insured in the unlikely event of a bank failure. Most deposit insurance institutions are established by the government. It may or may not be a part of a

MALAYSIAN DEPOSIT INSURANCE CORPORATION

Introduction

The statutory body administering the deposit insurance in Malaysia is Perbadanan Insurans Deposit Malaysia (MDIC). The idea to establish the system was inspired by Malaysia's Financial Sector Master Plan that recommended the establishment of a deposit insurance system. While Bank Negara Malaysia (BNM) remains the banking sector's primary regulator, MDIC complements the central bank's role in promoting financial stability in a way that encourages prudent risk management by member institutions. To avoid duplication of function, the MDIC Act sets out the coordination of roles and functions between MDIC and BNM regarding exchange of information. MDIC relies on BNM for information about the safety and soundness of member institutions, including their financial health. MDIC contributes to the stable financial environment by dealing with troubled member institutions expeditiously, preventing it from affecting the overall banking system. In carrying out its mandate, MDIC is empowered to acquire assets and shares of member institutions, make loans with or without security and take all other necessary measures.

Membership and Funding

Member institutions include all commercial banks including foreign banks operating in Malaysia. Finance companies licensed under the Banking and Finance Institutions Act 1989 (BAFIA) and all Islamic banks licensed under the Islamic Banking Act 1983 are included in this mandatory membership. At present MDIC has 35 members, comprising of 22 commercial banks and 13 Islamic banks. The Malaysian deposit insurance system was designed specifically to meet Malaysian needs. Due to the dual banking systems in the country, the deposit insurance provides coverage both to the conventional and Islamic deposits under one organization.

All member institutions are responsible to pay annual premiums to fund the deposit system, thus there is no direct cost to depositors for deposit insurance. This fund will be used to reimburse depositor claims should a member institution fail. In 2006 and 2007, member institutions are subject to a flat premium rate based on the total insured deposits held. From the year 2008, it is proposed that a differential premium system be implemented. Under the new system, premium rate will be based on member institutions

risk profile. Since the dual insurance system provides coverage for both Islamic and conventional deposits, MDIC maintains and administers two separate deposit insurance funds, namely:

- i) *Islamic Deposit Insurance Fund:*
Comprise of all premiums received by MDIC and returns made minus the direct cost of operating an Islamic deposit insurance system.
- ii) *Conventional Deposit Insurance Fund:*
Comprise of all premiums received by MDIC and interest earned minus the cost of operating a conventional deposit insurance system.

In the unlikely event of a bank failure, MDIC will reimburse the insured deposits (up to the covered amount) within three months time. Payment will be based on the member institution's record, therefore, depositors do not have to file claim. If depositors exceed the limit insured, he shall be entitled to participate as creditor in the liquidation process of the failed bank.

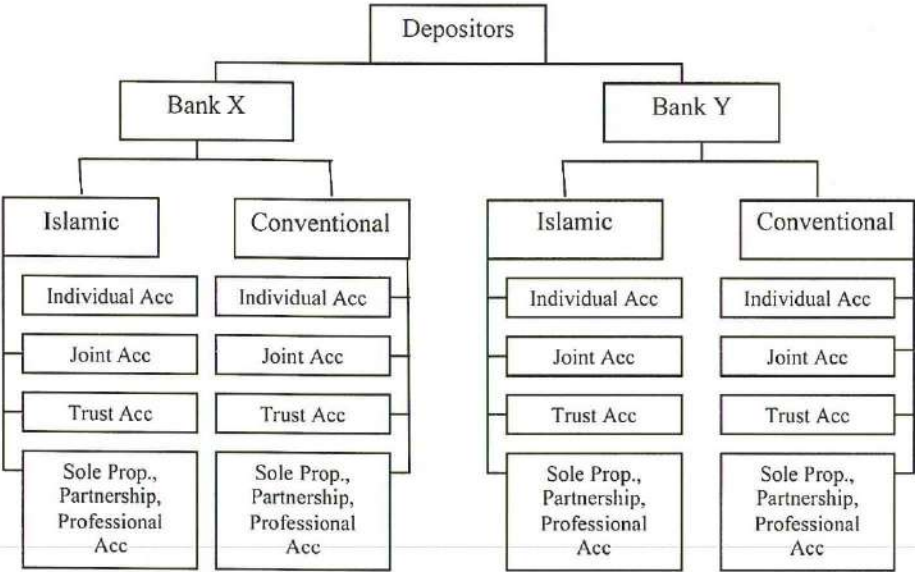
Coverage

MDIC provides numerous types of depositors, whether individuals, businesses, societies or associations, so long as the deposit is denominated in Ringgit Malaysia and payable in Malaysia. Insurable deposits include:

- i) All deposit products including current, savings, fixed and investment deposits
- ii) Certified cheques, bank drafts and other similar payment instructions drawn or made against a deposit account
- iii) Any other financial instruments as may be specified by MDIC

MDIC insures eligible deposits for up to RM60,000 per depositor per member institution. The RM60,000 limit includes both the principal amount of a deposit and the interest or return. The Islamic and conventional deposits are eligible for a separate coverage limit of RM60,000 each. Depositors are not allowed to buy additional coverage although they have deposits of more than the limit. RM60,000 is considered as adequate coverage limit because it covers approximately 95% of Malaysian depositors in full. Diagram 1 indicates the accounts that are covered under this scheme.

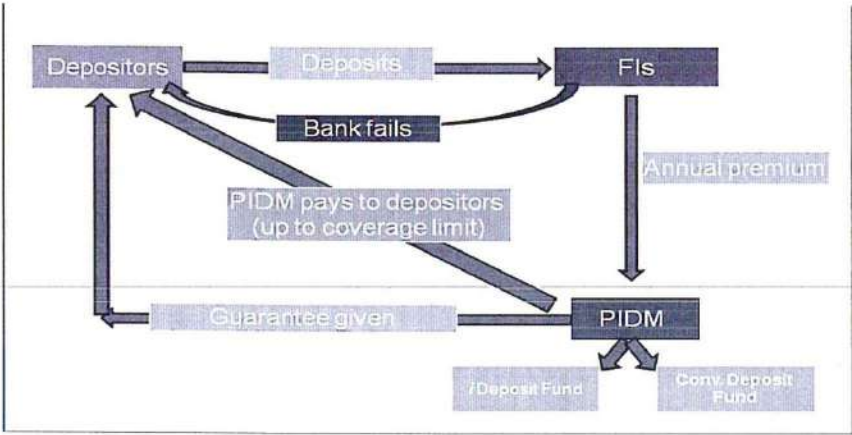
Diagram2: Accounts Covered Under MDIC Scheme



Source: MDIC

In terms of the operation of MDIC, the following diagram manifests the system accordingly:

Diagram 3: The Operation of MDIC



Source: Adapted from unprinted document by Hoda and Nusaybah, 2008

The above diagram shows that all depositors who deposited with financial institutions (member of MDIC) are guaranteed by MDIC for both Islamic deposits and conventional deposits. The guarantee is given in the case of failure of the FI with maximum coverage of RM 60,000.

SHARIAH PERSPECTIVE OF DEPOSIT INSURANCE

Introduction

The development of deposit insurance in Malaysia is still at the early stage and requires many improvements especially in the area of Shariah development. As discussed in the previous discussion, deposit insurance is a system that provides protection to depositors against loss of insured deposits placed in bank(s) in the event that a bank is unable to meet its financial obligations. If we relate the concept of protection in Islamic point of view, the system is similar to the concept of *takaful* in which it recognizes mutual protection and cooperation in order to minimize loss and provide material security of the contributors. A similar concept applies in deposit insurance whereby the depositors' deposits are guaranteed safe and any loss will be covered by a third party; i.e. MDIC.

Therefore, in this discussion, authors will relate the concept of deposit insurance to the concept of *kafalah* in Islam. Authors also will observe the Shariah general guideline of MDIC and its fund administration especially the Islamic deposits insurance fund. Finally, in this chapter, authors will review the ruling of Islamic deposit insurance applied by MDIC.

Shariah General Guideline of MDIC

As Islamic Financial Institutions pays an amount of fees to MDIC for the protection and guarantee of deposits, it is responsible to manage the fund accordingly. MDIC manages both funds; conventional fund and Islamic fund. In fact, Bank Negara Malaysia (BNM) conceived the concept of a separate Islamic deposit insurance system in relation to eligible Islamic deposits. This operates separately but parallel with the conventional deposit insurance system. To be spiritually assured, Islamic deposit insurance complies with Shariah principles and the structure of Islamic deposit insurance has been endorsed by the Malaysian Shariah Advisory Council on Islamic banking and Takaful. Similar to conventional practice, the Islamic deposit insurance system that is funded by the fees paid by Islamic banking institutions to MDIC is based on the total amount of insured Islamic deposits.

Fund Administration of Islamic deposits Insurance

Both the Islamic deposit insurance fund (from premiums collected on Islamic deposits) and the conventional deposit insurance fund (from conventional premiums) are administered by MDIC. However, as guided by Shariah Laws and governance, all Islamic deposit insurance funds should be invested based on Shariah principles, as guided by Shariah Advisory Council (SAC) of Bank Negara Malaysia and Security Commission via Islamic instruments. It is also managed separately from conventional fund to avoid uncertainty (*gharar*). This is to ensure that the fund is managed in a rightful and religious manner without any occurrence and participation of non-*halal* elements. In dealing with failure of Islamic Financial Institutions, the fund reimbursed to the depositors are also sought from Islamic fund and the fund would not allowed to be transferred to the other systems; conventional fund. In some events, MDIC may also receive Shariah-based fund from the government to operate the system.

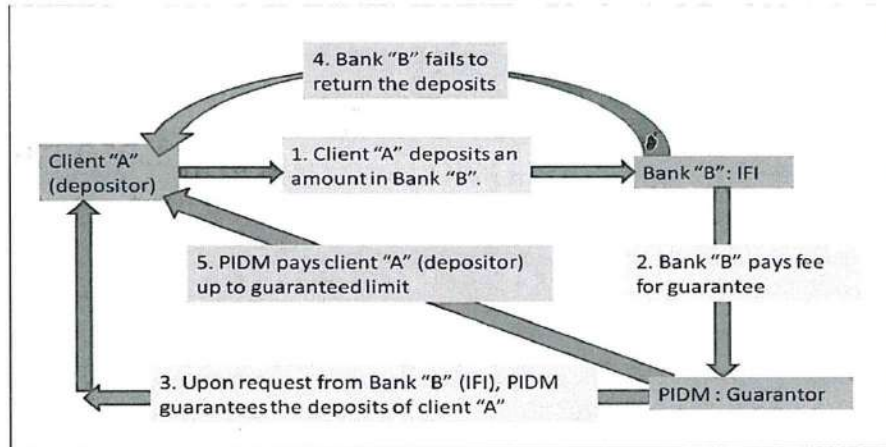
Shariah Ruling of Islamic Deposit Insurance

The deposit insurance (the insurance contract) is based on the concepts of *kafalah* (guarantee) and *tabarru'* (donation) to ensure that the Islamic deposit insurance system complies with Shariah principles. In line with these principles, the relevant member institutions make donations to the MDIC, which then provides depositors with insurance coverage and ensures pay-outs in the event of bank failure. In practice, the system runs when an IFI pays a premium which is considered as *tabarru'* and the bank guarantees for any loss appears from the deposit on the concept of *kafalah*.

All deposits in Islamic Financial Institutions in Malaysia are ruled by only two (2) contracts; *Wadiah Yad al-Dhamanah* (Safe-Keeping) and *Mudharabah* (Profit Sharing). These two contracts will bring the depositors in a situation where risk-sharing elements might be possible in any circumstances. Thus, MDIC acts as a third party to guarantee both types of deposits by having the IFIs as contributors in the insurance system. At this juncture, the MDIC acts as *kafil* (3rd party guarantor), the lender/client (depositor) as *makful 'anhu* and the IFI act as borrower (*makful lahu*). This is applied in all *Wadiah* accounts; saving and current accounts. In *Mudharabah* account mainly for saving account, the MDIC acts as *kafil* (3rd party guarantor), the capital provider/client (depositor) as *makful 'anhu* and the IFI act as entrepreneur (*makful lahu*).

To provide a better view of this system based on the concept of guarantee, the following diagram is referred:

Diagram 4: The Operation of *Kafalah* Structure in MDIC



Source: Adopted from unprinted document by Hoda and Nusaybah, 2008

In the above diagram, an example of a client who deposited an amount in a bank member will automatically receive bank guarantee for the deposit (No.1). The bank that pays a premium to MDIC/PIDM (No.3) that has been appointed as third party guarantor (No.3) will pay up to maximum limit for any loss and failure on the part of the bank (No.4). The payout from MDIC/PIDM will go directly to the depositors. (No.5).

It should be noted that guaranteeing deposits in Islamic bankings involves two basic contracts; *wadiah* and *mudharabah*. As for *wadiah* contract, the element of *dhaman* is applicable automatically and deposit insurance resumes the initial status of *wadiah* contract. Thus, security on the principle amount is a must on behalf of the bank. However, for *mudharabah* account, the situation is different since risk element by nature will exist and affect the investment. This discussion on its Shariah status is to be discussed in future study.

FINDINGS OF THE SURVEY

Methodology

A short survey questionnaire was designed to examine the respondents' level of awareness on deposit insurance. The questionnaire was constructed based on the findings of the literature and pilot-tested for content validity. The sampling frame used for the study 136 students of the Faculty of Economics and Muamalat, USIM. These students are selected because banking, insurance and takaful subjects are included in the university curricula. Therefore, respondents are assumed to have some background knowledge on the issues being discussed.

The data for this study were collected by self-administered questionnaires distributed by the researchers at August, 2008. The respondents were selected using disproportionate stratified random sampling method.

Survey Instrument

The questionnaire consists of four sections. Section A covers respondents' profile; Section B examines the respondents' types of bank accounts. Section C investigates the respondents' awareness of insurance deposit and Section D looks at the level of knowledge on the scheme.

27 structured questions are included in the survey questionnaire. The questions are mostly dichotomous in nature, eliciting either 'Yes' or 'No' options. 5 point Likert-scale questions are included in Section D.

A simple descriptive analysis of the mean, maximum value and minimum value on selected variables were performed on the data using Statistical Packages for Social Sciences (SPSS) software package. The findings would hopefully provide certain insights towards the level of knowledge on deposit insurance among the respondents.

Data Analysis

In general, majority of the respondents are female and between 16 to 25 years of age. Most of them are from the East Coast. 91.2 percent of the respondents have savings account, with Bank Islam Malaysia Berhad (BIMB) as the preferred bank. 75 percent

of the respondents have savings of less than RM1,000. Almost 78 percent of the respondents have heard of deposit insurance. They heard of the scheme mostly through the media and university/college. Almost all of the respondents are interested to learn more about deposit insurance in the future. The overall respondents' profile is presented in Table 1.

Table 1: Overall Respondents' Profile

| | Frequency | Percentage |
|--|------------|------------|
| Gender | | |
| Male | 27 | 19.9 |
| Female | 109 | 80.1 |
| <i>Total</i> | <i>136</i> | <i>100</i> |
| Age | | |
| 16 – 25 | 133 | 97.8 |
| 26 – 35 | 3 | 2.2 |
| <i>Total</i> | <i>136</i> | <i>100</i> |
| Year | | |
| 1 | 2 | 1.5 |
| 2 | 24 | 17.6 |
| 3 | 81 | 59.6 |
| 4 | 29 | 21.3 |
| <i>Total</i> | <i>136</i> | <i>100</i> |
| Location | | |
| North | 19 | 14 |
| East | 68 | 50 |
| Selangor, Negeri Sembilan, and Kuala Lumpur | 30 | 22.1 |
| South | 16 | 11.8 |
| Sabah & S'wak | 3 | 2.2 |
| <i>Total</i> | <i>136</i> | <i>100</i> |
| Job Sector | | |
| Government | 86 | 63.2 |
| Private | 14 | 10.3 |
| Self-employed | 21 | 15.4 |
| Others | 15 | 11 |
| <i>Total</i> | <i>136</i> | <i>100</i> |

Type of Account

| | | |
|--------------|------------|------------|
| Savings | 124 | 91.2 |
| Current | 4 | 2.9 |
| Investment | 8 | 5.9 |
| <i>Total</i> | <i>136</i> | <i>100</i> |

Bank

| | | |
|--------------------------|------------|------------|
| Bank Islam Malaysia Bhd. | 134 | 98.5 |
| Malayan Banking Bhd. | 16 | 11.8 |
| Others | 54 | 39.7 |
| <i>Total</i> | <i>136</i> | <i>100</i> |

Savings Amount

| | | |
|--------------|------------|------------|
| < 500 | 54 | 39.7 |
| 501 - 1000 | 48 | 35.3 |
| 1001 - 2000 | 21 | 15.4 |
| 2001 - 3000 | 8 | 5.9 |
| > 5001 | 3 | 2.2 |
| <i>Total</i> | <i>136</i> | <i>100</i> |

Heard of DI

| | | |
|--------------|------------|------------|
| Yes | 106 | 77.9 |
| No | 30 | 22.1 |
| <i>Total</i> | <i>136</i> | <i>100</i> |

Source of Info

| | | |
|------------------------|------------|------------|
| Financial Institutions | 36 | 26.5 |
| Media | 42 | 30.9 |
| Promotional Tools | 32 | 23.5 |
| Network | 22 | 16.2 |
| University | 42 | 30.9 |
| <i>Total</i> | <i>136</i> | <i>100</i> |

Interested to Know

| | | |
|--------------|------------|------------|
| Yes | 126 | 92.6 |
| Know | 10 | 7.4 |
| <i>Total</i> | <i>136</i> | <i>100</i> |

Source: Survey

The questions pertaining to knowledge of deposit insurance scheme provided by MDIC are covered in Section D of the questionnaire. Respondents were asked to self-rate themselves based on 5-point Likert-type questions. The value of '1' denotes 'Strongly Disagree'; the value '5' denotes 'Strongly Agree' while the value of '3' indicates a neutral position.

Based on the survey, the deposit insurance objective recorded the highest mean score of 3.97. The lowest mean score of 3.26 was reported for question on coverage limit of the scheme. Respondents gave high scores to questions pertaining to the aim of deposit insurance and the membership of the scheme. Most respondents understand that their deposits in all commercial banks and Islamic banks are protected under this scheme. The respondents also have some ideas as to the types of accounts that are insured. However, scores are relatively lower for questions on the non-insured deposits and the maximum limit of coverage. Most respondents are also not sure whether MDIC provided separate coverage for Islamic and conventional deposits. However, interestingly, the respondents do know that the protection provided by MDIC is free. The statistics on the knowledge of deposit insurance is listed in Table 2.

Table 2: Descriptive Statistics on Knowledge of Deposit Insurance

| Questions | Score | | |
|--|-------|-----|-----|
| | Mean | Min | Max |
| 1. Aims of Deposit Insurance | 3.97 | 1 | 5 |
| 2. Membership: Local Bank and FI | 3.59 | 1 | 5 |
| 3. Membership: Foreign Bank and FI | 3.82 | 1 | 5 |
| 4. Membership: Islamic Banks | 3.67 | 1 | 5 |
| 5. Insured deposits | 3.51 | 1 | 5 |
| 6. Non- Insured deposits | 3.36 | 1 | 5 |
| 7. Maximum Limit Coverage | 3.26 | 1 | 5 |
| 8. Separate coverage for Islamic and Conventional deposits | 3.32 | 1 | 5 |
| 9. Payment of premium by FI | 3.63 | 1 | 5 |

Source: Survey

Conclusion

It is viable to acknowledge that the execution of deposit insurance in Malaysia by MDIC provides a solution to “bank runs” especially in the instability of performance of banking sectors. This insurance provides material assurance and serenity for the depositors by protecting their rights. In addition, the coverage also promotes financial stability in the way that it helps the industry to maintain public confidence towards banks.

However, knowledge and understanding of our young generation especially the respondents from Faculty of Economics and Muamalat is still moderate. With active promotions in media by MDIC, they still did not grasp the whole information correctly. Based on the score shown in the analysis, it is generally wise to say that respondents are moderate in terms of knowledge and understanding on the operation, system and general information of MDIC.

It is hoped that society will be more attentive and responsive with the deposit insurance system and its running. The awareness is important to ensure that a controlled situation will take place when there is failure of any of the banks. Depositors should be in control and be familiar with all procedures that they require to do, as this troublesome situation is not yet experienced in Malaysia.

On the part of the financial institutions, uplifted and catchy promotions should be initiated to project awareness and promote knowledge among customers. Besides, MIDC should continue its active campaign and advertisement to build confidence among Malaysian on Malaysia financial institutions.

References

- Diamond DW, Dybvig PH (1983). ‘*Bank runs, deposit insurance and liquidity*’ (PDF).J Pol Econ 91 (3): 401-19. <http://minneapolisfed.org/research/QR?QR2412.pdf>. Retrieved on 1st July 2009
- MDIC Handbook: *Insuring Your Deposits*. 2009
- Malaysia Deposit Insurance Corporation (MDIC). 26th May 2006 . The Islamic Deposit Insurance System – A Malaysian Experience in Islamic Finance News. P. 14
- Muhammad Fahim Khan. *Guaranteeing Investment Deposits in Islamic Banking System*. Journal of Islamic Economics. University iof King Abdul Aziz. 2003. Vol. 16, No. 1. P. 45-52

Amir Shaharuddin. *A Juristic Perspective on Deposit Guarantee in Islamic Bank.*
Muamalat: The Newsletter of the Faculty of Economics and Muamalat.
2009/2010. Vol. 8, No. 1. P. 2

Unprinted document by Hoda and Nusaybah, *Deposit Insurance: Islamic Perspective*,
presented in Class Seminar of Islamic Law of Banking and Securities, 2008