

FINANCIAL FLAGSHIP

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# DEPOSIT INSURANCE IN THE MENA REGION

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## 1. Purpose and Introduction

This paper has been prepared by Mohammed Al-Ja'fari of Jordan Deposit Insurance Corporation (JODIC) and David Walker of Canada Deposit Insurance Corporation (CDIC) to assist the World Bank (WB) in the preparation of its flagship study on the resilience of financial systems in the Middle East and North Africa (MENA) region.<sup>1</sup> The analysis covers MENA countries according to the WB geographical classifications. It evaluates existing explicit deposit insurance systems in the region by benchmarking them to the Basel Committee on Banking Supervision (BCBS)/ the International Association of Deposit Insurers (IADI) Core Principles for Effective Deposit Insurance Systems (Core Principles).<sup>2</sup> It also examines and evaluates the views supporting the persistence of blanket government guarantees (both explicit and implicit) in place in a number of MENA countries.<sup>3</sup>

The number of explicit limited deposit insurance systems in the MENA region has increased rapidly over the last ten years. Countries that still rely on blanket guarantees are mainly the oil exporting countries and those with clear state control of the banking system. Policymakers in these countries believe that the political, economic and financial conditions do not currently support transitioning away from blanket guarantees. In particular, those countries that provided explicit deposit guarantees in certain MENA countries during the latest global financial crisis are proceeding cautiously in ending such guarantees given the continued fragility of financial systems worldwide.

Properly designed explicit (rules-based) limited coverage deposit insurance systems can support market discipline and help improve competitiveness. They limit regulatory forbearance and accordingly can reduce the direct financial cost of bank resolutions. However, the adoption of an explicit limited system requires the removal of blanket guarantees which may create market instability or outright panic if certain political, economical and financial prerequisites are not met.

Policy resistance to transitioning away from blanket guarantees stems from fears of market panic during the transitioning process and the limitation of policy choices in such circumstances. For those MENA financial systems adopting publicly-announced prompt-corrective action regimes the latter consideration is particularly relevant.

However, evidence from countries around the world that have successfully transitioned shows the importance of creating an environment characterized beforehand by healthy banking systems and stable economic and financial conditions. The focus in the MENA region should, in turn, be

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<sup>1</sup> This paper was prepared on a request from the World Bank and the views expressed in the paper are those of the authors and strictly for the World Bank purposes, they do not necessarily represent the views of the JODIC, CDIC or the International Association of Deposit Insurers (IADI).

<sup>2</sup> The MENA countries reviewed in this paper were benchmarked against the BCBS/IADI Core Principles at a high level. A detailed Core Principles Assessment Methodology has been prepared by IADI, BCBS, IMF, WB, the European Forum of Deposit Insurers (EFDI) and the European Commission (UC) and is currently being considered by the Financial Stability Board for adoption.

<sup>3</sup> See BCBS/IADI (June 2009).

directed to building these necessary preconditions and transitioning to limited coverage systems as soon as the circumstances permit.

Existing explicit deposit insurance systems in the region provide varying levels of coverage reflecting fundamental economic and financial differences. Key design feature of those systems are largely in line with the IADI Core Principles. They are either pure “paybox” systems managed directly by the Central Bank or administratively independent organizations governed by a board of directors and chaired by the Central Bank governor. The mandate of the administratively independent organizations is wider than pure paybox systems and typically includes receivership and liquidation responsibilities.

The following analysis emphasizes the importance of establishing properly designed deposit insurance systems in the MENA region that avoid either explicit or implicit blanket guarantees. It also highlights the need to improve many of the existing limited coverage systems in the MENA countries. This can help encourage banks to better manage their risks, cut down on the cost of bank failures and thereby save public funds, contain the contagion effect of financial crises, provide formal mechanisms for resolving failed banks, and enhance confidence in the financial system. The current explicit or implicit blanket guarantees in the MENA region, if continued for long periods, will increase negative incentives such as moral hazard.

The following sections (II, III, IV and V) identify the scope of analysis for the paper, highlight the role of deposit insurance in contributing to financial stability and provide an analysis of the existing explicit deposit insurance systems in the MENA region and their design features. Section VI evaluates blanket government guarantees in the region and evaluates their implications. Deposit Insurance in countries with a large presence of state-owned banks is discussed in section VII.

The withdrawal of the blanket guarantees along with the conditions for effective transition to limited coverage system are discussed in sections VIII. Section IX discusses the insurability of Shariah-based deposits followed by a summary of the main challenges and the envisaged way forward in section X.

## **2. Scope of Analysis:**

The mission of the IADI is to share deposit insurance experience with the world. IADI promotes sound practices and effective design features for explicit limited-coverage deposit insurance systems. Four explicit limited deposit insurance systems in the MENA region (Jordan, Lebanon, Morocco and Sudan) are represented in the IADI and five systems (Algeria, Bahrain, Libya, Oman and Yemen), are considering membership in the Association. The Algerian Central Bank is the only Central Bank in the MENA region that enjoys an associate status at IADI. The Union of Arab Banks has partnership arrangements with the Association. The MENA regional interests are represented by the MENA regional committee at the IADI Executive Council. The regional committee is involved in most of the Association’s activities, particularly with respect to the development of the Core Principles and research and guidance papers.

The following study has been prepared at the request of the WB in order to provide background material and policy recommendations regarding deposit insurance in the MENA region. All countries in the MENA region according to the WB geographical classification are included in

the analysis.<sup>4</sup> The study covers explicit limited deposit insurance systems along with the informal schemes in the remaining countries providing either explicit or implicit blanket guarantees.

### **3. Role of Deposit Insurance in Contributing to Financial Stability**

In most economies banks play the major role among financial institutions in intermediating between savers and investors, in the operation of the payment system and the execution of monetary policy.<sup>5</sup> The importance of banks in an economy, the potential for depositors to suffer losses when banks fail, and the need to mitigate "runs" and "contagion" risks, have lead many countries to establish financial system safety-nets.<sup>6</sup> These usually include prudential regulation and supervision, bank resolution regimes for dealing with troubled or insolvent banks, a lender of last resort facility and, increasingly, some form of deposit insurance.<sup>7</sup>

A deposit insurance system provides explicit- but limited- protection for eligible depositors in the event of a bank failure.<sup>8</sup> Deposit insurance can be designed to fulfill a variety of goals. However, the most common objectives are to contribute to financial system stability and to protect smaller and less financially sophisticated depositors from loss.<sup>9</sup> Without a credible deposit insurance system in place, the possibility exists that depositors might "run" by removing their deposits from a bank, and/or other banks, in response to difficulties at a single bank.<sup>10</sup>

The design of deposit insurance systems generally involves tradeoffs and the potential for introducing distortions into the financial system.<sup>11</sup> The most notable potential distortion in introducing deposit insurance into a financial system is the possibility of creating moral hazard,

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<sup>4</sup> Includes the following jurisdictions: Algeria, Bahrain, Egypt, Iran, Iraq, Jordan, Kuwait, Lebanon, Libya, Morocco, Oman, Qatar, Saudi Arabia, Syria, Tunisia, United Arab of Emirates, West Bank and Gaza, and Yemen.

<sup>5</sup> FSF Working Group (2001a).

<sup>6</sup> In this paper the term "bank" is used to denote all financial institutions which accept deposits from the general public. The term "run" is defined as a rapid loss of deposits precipitated by fear on the part of the public that a bank may fail and depositors may suffer losses. "Contagion" refers to the spread of individual bank runs to other institutions.

<sup>7</sup> In most economies, the monetary authority typically supplies lender of last resort (LOLR) facilities to troubled banks. LOLR loans are in principle provided to illiquid but solvent banks and at a penalty rate.

<sup>8</sup> Implicit deposit protection arrangements exist where depositors believe they will receive full protection in the event of a bank failure. However, most deposit protection arrangements are explicit and stipulate in legislation the rules governing the terms and conditions of protection. Explicit deposit insurance is viewed as being preferable to implicit protection because it reduces uncertainty and risk for depositors and can be helpful in reducing expectations on the part of the public of full government support in the event of a bank failure. Although some argue that a degree of uncertainty can lead depositors to exert greater effort in monitoring banks, in reality most depositors are not capable of doing so and/or do not have the necessary information or incentives to effectively monitor banks. For more information, see: FSF Working Group (2001a) and Garcia (2000).

<sup>9</sup> Other less common objectives for deposit insurance include: enhancing competition; providing a mechanism to close troubled banks; and ensuring that resolution costs are absorbed by the banking industry. See also CDIC (2003) and Garcia (1999).

<sup>10</sup> See Diamond and Dybvig (1983).

<sup>11</sup> See Campbell et al (2007) and Walker (2007).

or the incentive for excessive risk taking by banks or those receiving the benefit of a guarantee of protection. For example, full coverage for all deposits (e.g. blanket guarantees) would effect the greatest protection for depositors but at the same time present the greatest challenge for controlling moral hazard. At the other end of the spectrum, very low coverage levels -- that do not protect the majority of depositors in the system -- would not be effective at curtailing runs and protecting the savings of most depositors. Therefore designers of deposit insurance systems must choose coverage levels which provide adequate protection but which do not create excessive distortions such as moral hazard.<sup>12</sup>

Moreover, even a well-designed deposit insurance system needs to be supported externally by strong prudential regulation and supervision, an effective legal system, sound corporate governance and risk management in banks and appropriate accounting standards and disclosure regimes.

Although deposit insurance is effective at protecting depositors and contributing to stability in most situations, it cannot by itself deal with a systemic financial system crisis.<sup>13</sup> Systemic crises require the combined efforts of all safety-net participants to effectively deal with them. Deposit insurance systems are most effective at dealing with single failures or a wave of small failures.<sup>14</sup>

#### **4. Explicit Deposit Insurance Systems in the MENA Region**

There are eight deposit insurance systems in the MENA region. The Lebanese system (Institut National de Garantie des Dépôts) was the first one to be established after the failure of Intra Bank in 1967. It was created mainly to carry out the liquidation process and to reimburse depositors. The liquidation of Intra Bank, which has not been completed to date, has been very costly as the Lebanese authorities decided to cover all deposits to maintain stability given its significant market share (the bank held about 38% of the Lebanese banks' deposits and 15% of the total banking sector deposits at the date of liquidation). The next two systems were created in 1993 in Bahrain and Morocco as pure paybox systems under the Central Bank management. Oman established its system as a pure paybox system under the Central Bank management in 1995. The following systems were established as operationally independent systems: Sudan, Algeria, Jordan and Yemen in 1996, 1997, 2000 and 2008 respectively. Lastly the legislation for the Libyan paybox system was approved under the Central Bank management in early 2010.

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<sup>12</sup> In addition to limiting coverage there are numerous other design features which can help minimize moral hazard including: the use of differential or “risk-adjusted” premiums; the introduction of certain forms of co-insurance; and minimising the risk of loss through early closure of troubled banks. As noted in the Core Principles Methodology for Compliance Assessment at footnote 10, the use of co-insurance presents a number of serious problems, including the possibility of creating “strong incentives for depositors to run on a bank to avoid even a small loss of their funds.”

<sup>13</sup> A “systemic crisis” is defined as a crisis situation which affects and seriously threatens the viability of the entire financial system. See Core Principles Methodology at Annex 4.

<sup>14</sup> See FSF Working Group (2001a); Core Principles Methodology at Annex 4.

**Table 1 Classification of Deposit Insurance Prevailing in the MENA Region**

Countries with explicit limited-coverage deposit insurance systems	Countries with Blanket Coverage	
	Implicit Blanket Coverage	Explicit Blanket Coverage
Algeria Bahrain Jordan Lebanon Libya <sup>15</sup> Morocco Oman Yemen	Qatar Iraq Tunisia Syria <sup>16</sup> Iran West Bank and Gaza Strip <sup>17</sup>	United Arab Emirates <sup>18</sup> Kuwait Jordan <sup>19</sup> Saudi Arabia <sup>20</sup> Egypt <sup>21</sup>

## **5. Benchmarking of MENA Explicit Deposit Insurance System Design Features with the Core Principles for Effective Deposit Insurance Systems**

The main design features for these systems are analyzed in this section to identify the nature and context of any weaknesses by benchmarking the systems against the Core Principles. The analysis is intended also to aid deposit insurers and policymakers in the region in making improvements to both the systems and the financial safety-net at large. The key areas where there is divergence from international standards and trends in other countries are also highlighted. A summary of key design features are presented in Table 2.

### *5.1 Objectives, Mandates and Powers*

The most common public policy objectives of the explicit deposit insurance systems in MENA region are to promote confidence and stability in the banking system and to pay off deposits in the event of the closure of an insured institution (i.e. bank). Morocco has the additional objective of the provision of financial assistance to ailing banks.

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<sup>15</sup> The regulation for the establishment of the limited coverage system was enacted and system started operations in April 2010.

<sup>16</sup> The Central Bank of Syria is currently working on a draft law for a limited-coverage system that is expected to be adopted during 2011.

<sup>17</sup> The Central Bank of the Palestinian Authority has requested technical assistance from the WB to set up a limited coverage system.

<sup>18</sup> The blanket guarantee was adopted by a regulation for three years ending in November 2011.

<sup>19</sup> The explicit blanket guarantee was introduced by political announcement with an expiry date set for the end of 2009. However, it was extended up until the end of 2010.

<sup>20</sup> A statement was made by the higher economic council at the outset of the global financial crisis indicating that the government would ensure the safety of deposits and financial soundness of banks but the government did not specify a term limit.

<sup>21</sup> Several political statements were made on different occasions, according to the Minister of Investment, indicating the government would provide a blanket guarantee of all deposits.

Deposit insurer mandates vary from relatively narrow "paybox" models concentrating on the reimbursement of depositors of failed banks (e.g. Lebanon, Bahrain, Algeria, Oman and Morocco) to systems with broader mandates encompassing roles in bank licensing (e.g. Sudan and Yemen), accessing information directly from banks for the purposes of determining deposit levels and setting premiums and undertaking joint examinations with supervisors (e.g. Jordan and Libya).

In all the systems reviewed the public policy objectives, mandates and powers were clearly defined and formally specified. However, the mandate for paybox systems with extended powers in the region assigns the liquidation responsibilities for the deposit insurer without the necessary resolution authorities also being assigned to those insurers.

### *5.2 Structure, Organization and Governance Arrangements*

The deposit insurance systems in Lebanon, Sudan, Algeria, Jordan, and Yemen are structured as legally separate organizations and governed by a board of directors. Commercial bankers are present on the boards of directors in the Sudanese and Omani systems, which presents the issue of how best to have access to confidential information on banks without creating the potential for such information to be shared with competitors of those banks in the financial community. The systems in Bahrain, Morocco and Oman are pure paybox systems administered directly by the Central Bank, but Oman has a Board of Directors with both Central Bank employees and commercial bank representatives on the board. The degree to which those systems follow good governance practices (i.e. operational independence, accountability, integrity, transparency) is uneven.

Given the information provided, few if any of the MENA deposit insurers and those working for them enjoy statutory indemnification and legal protection, although in some countries there is general legal protection for civil servants. Some deposit insurers or other authorities in the region are able to seek legal redress against those parties at fault in a bank failure.

### *5.3 Information Sharing and Inter-Relationships between Safety-Net Players*

Information sharing and coordination of the activities of the deposit insurer and other safety-net players was a high priority for the deposit insurers reviewed. Depending on country circumstances, insurers reported using both formal and informal mechanisms to exchange information and coordinate their activities. Formal arrangements were present in Sudan, Yemen, Jordan, Oman and Bahrain but not in Lebanon, Algeria and Morocco, although informal information sharing arrangements are in place.

### *5.4 Membership and Coverage*

All the MENA deposit insurance systems require mandatory membership for banks. In Jordan, membership is compulsory for all banks and voluntary for Islamic banks. The licensing authority is the Central Bank and none of the deposit insurers have the authority to revoke a bank license or to terminate its membership. All deposit insurers provide the same coverage for foreign banks and their branches as they do for domestic banks. Foreign currency deposits are covered in Oman, Bahrain, Algeria, Lebanon and Morocco.



The level of coverage in the MENA deposit insurance systems varies widely. As a share of per capita GDP it ranges from a low of 0.85 per cent in Sudan to a high of 8.4 per cent in Yemen. Most systems cover core demand and savings deposit products. Coverage generally excludes non-deposit products such as equities and bonds. Despite the increase in Islamic banking activities in the region, only Sudan and Yemen insure Shariah-based deposits despite the significant improvements that took place in the operational and Shariah research concerning the permissibility of insuring Shariah-based deposits (See Annex 1).

### *5.5 Funding and Fund Management*

The most predominant form of funding in the MENA region is ex-ante and combined ex-ante and ex-post funding. However, only Bahrain relied exclusively on ex-post funding<sup>22</sup>. Information on fund sufficiency in the form of targeted fund reserve ratios (funds as a per cent of total deposits) is available for Jordan (3 per cent), Yemen (3 per cent) and Oman (2.7 per cent) but not for the remaining countries studied.

Premiums are collected on a flat-rate basis and ranged from a low of 5-15 basis points of total deposits (Lebanon) to a high of 250 basis points for Algeria. All countries in the region use a base of total deposits as opposed to insured deposits for determining premiums. The average rate charged for the MENA region depositors was approximately 30 basis points. None of the MENA countries apply a risk-based premium system.

The ability of the MENA deposit insurers to access emergency supplementary funding is in place for Sudan, Yemen, Jordan and Lebanon. The systems in Oman, Bahrain, Algeria and Morocco do not have access to supplementary funding. Investment policies used in the region generally restrict deposit insurance fund investments to low-risk securities consistent with international best practices.

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<sup>22</sup> The system is being currently reviewed to become ex-ante funded.

**Table 2. Key Design Features for MENA Deposit Insurance Systems**

DI System	Algeria	Bahrain	Jordan	Lebanon	Libya	Morocco	Oman	Yemen
<b>Year of Establishment</b>	1997	1993	2000	1967	2010	1993	1995	2008
<b>Mandate</b>	Paybox	Paybox	Paybox with extended powers	Paybox with extended powers	Paybox with extended powers	Paybox	Paybox	Paybox with extended powers
<b>Maximum Protection Level (in Local Currency)</b>	600,000	20,000	10,000	5,000,000	250,000 <sup>(2)</sup>	80,000	20,000	3,000,000
<b>Maximum Protection Level (in US Dollar)</b>	8,440	39,790	14,105	3,310	189,400	9,411	51,950	9,990
<b>Maximum Protection Level/ Per Capita GDP</b>	1.7	1.5	3.7	0.5	14.2	3.7	3.4	8.4
<b>Premium Ratio<sup>(1)</sup> (Basis Points)</b>	25	---	25	15	---	20 with a maximum of 25	10-50	20
<b>Funding</b>	Ex- ante	Ex- post	Ex- ante	Ex- ante	Ex-ante Ex-post	Ex-ante	Ex- ante Ex- post	Ex- ante
<b>Managed by</b>	Independent Board	Central Bank	Independent Board	Independent Board	Independent Board	Central Bank	Central Bank	Independent Board

<sup>(1)</sup> Annual premiums collected from member banks are supplemented by equivalent Treasury contributions in Lebanon. The Central Bank of Oman contributes 50% of the total value of annual premiums collected. A supplementary premium of 5% from the Treasury and Central Bank is collected in Yemen. The system in Bahrain, however, is fully funded by annual contributions from the Treasury (25 million Dirham annually).

<sup>(2)</sup> Coinsurance applies.

<sup>(3)</sup> The premium rate has not been set as of paper writing.

### 5.6 Reimbursing Depositors

Most systems have a goal of reimbursing depositors within a 60-90 day period from the date of closure of a failed bank. However, it is unclear how effective deposit insurers will be in meeting these targets if required to undertake an actual reimbursement. International trends in this area are moving towards significantly shorter periods (i.e. less than 30 days).

### *5.7 Public Information and Awareness*

Public awareness programs that provide information to depositors on an ongoing basis are an increasingly common feature of deposit insurers around the world. However, such programs are still not widespread in the MENA region. The exceptions are Jordan and Sudan where the deposit insurer communicates on an ongoing basis with the public through a well-developed public awareness program.

### *5.8 Failure Resolution*

Basically all deposit insurance systems in the MENA region have limited mandates. Only a small number of the MENA deposit insurers have a direct role in non-payout/liquidation resolutions, such as by providing funds for non-liquidation options for resolving banks. Jordan and Yemen have the power to undertake sales and purchase and assumption of a part or the whole of a troubled bank while the systems in Morocco, Lebanon and Bahrain may undertake open bank assistance. The needed authorities for mostly possible resolutions rest in general at the Central Banks.

### *5.9 Summary*

In summary, the key areas where there is a divergence from international principles and trends in the MENA region are:

- The degree to which MENA systems follow good governance practices are uneven and deficiencies need to be addressed.
- Lack of legal protection for those working for the deposit insurance system is another area of concern. Very few MENA countries have in place the necessary protection for employees. However, this will be challenging to address given that the lack of legal protection is the norm throughout the safety-net in many of these nations.
- Better access to emergency liquidity needs to be addressed in a number of MENA countries, particularly if a move towards more limited explicit deposit insurance is to take place.
- More focus needs to be placed on public awareness as it is not a widespread practice in the region.
- Enhancements to crisis preparedness and planning are being undertaken in many MENA countries. However, the deposit insurance systems in the region are not well integrated into these arrangements. The international financial crisis showed that deposit insurers need to be better integrated into such planning.

## **6. Blanket Guarantees in the MENA Region**

Blanket guarantees prevail to some degree in almost all countries in the MENA region, including those that adopt explicit limited-coverage deposit insurance systems. Some of these guarantees are explicit and adopted recently as part of policy responses to the latest financial crisis. These

were adopted by political statements in Egypt, Saudi Arabia and Jordan while regulations were enacted to provide the guarantees in Kuwait and the United Arab Emirates. Other blanket guarantees are implicit as forbearance in the region is widespread as shown by the continued government support of any banks facing financial difficulties, whether transitory liquidity problems or actual insolvencies. Direct government involvement in management is present in the region and policymakers proved to be ready to take whatever actions needed to avoid bank failure and liquidation. The main justifications used in the MENA countries for sustaining the current blanket guarantees are as follows:

### *6.1 Public Panic Avoidance*

Fears of hurting public confidence (and possibly panics and runs) is the main reason policymakers have avoided the establishment of a limited coverage system. Constructive ambiguity under an implicit blanket guarantee is considered an important element for maintaining financial stability by policymakers. It also explains the delays in the creation of the explicit deposit insurance systems in many countries despite having the legal authority and the relevant regulations in place in countries such as Egypt and Tunisia. Even for countries that have their systems in place, it took long periods of time to implement the systems.

### *6.2 Cost of Failure*

Bank failures are expensive and liquidation is considered a disruptive form of resolution and usually the last option to resolve a failing bank. Experiences in the MENA region indicate that in many countries the authorities have provided significant direct financial support to keep banks operating on an ongoing concern basis as long as possible in order to avoid instability and provide time to contemplate all possible resolutions. The creation of a limited coverage deposit insurance system with a formal resolution mechanism may limit some policy choices in dealing with bank failures.

### *6.3 Sufficient Budgetary Resources*

Expectations about state responsibilities towards the public in countries with large budgetary and current account surpluses is another factor. Accumulated official surpluses are expected to be used to resolve any financial or economic crisis regardless of the cost. Authorities believe that the public cannot accept the idea of losing even a part of their deposits held by banks when the government has sufficient resources to bail out any insolvent bank. The public in certain cases expects the government to bail out all bank debtors when large scale failures take place in the aftermath of the global financial crisis.

### *6.4 State Ownership of Banks*

Another important impediment to adopting limited guarantees is related to the state ownership of many banks in countries such as Egypt and Syria. Deposits held by state owned banks are guaranteed de facto. In Syria this guarantee is explicit by regulation. This state involvement impedes the introduction of limited coverage systems and effectively requires that blanket guarantees be extended to all banks. As state-owned banks are phased out and banking supervision and regulation are increased, the need for limited coverage deposit insurance systems is becoming more important in these countries.

## *6.5 Market Structure*

Many economies in the MENA region are relatively small and the banking industry is sizable but concentrated. Typically in the MENA countries as little as two to five banks can hold more than 10% of the market share individually and control around 80% of the value of total deposits. This structure makes many banks effectively “too-big-to-fail”.

## *6.6. Financing and Investment Structures*

In the MENA region, bank assets are mostly invested in loan portfolios, with limited investments in traded financial instruments. Banks face noticeable liquidity problems given their limited investments in liquid assets and the absence of a secondary market for government securities. The problem is even worse for Islamic banks that do not invest in a full range of fixed income securities. This asset-liability structure requires careful liquidity management focusing on holding relatively high excess reserves to meet any possible deposit run. Any moderate pressure on liquidity can eventually lead to bank failure if banks do not maintain highly liquid positions or don't receive liquidity support from regulators. When evaluating the pros and cons of introducing limited coverage deposit insurance systems, policymakers must consider the inability to liquidate assets in the case of deposit runs as a major limitation and be certain that adequate liquidity support is available to otherwise solvent banks.

Loan quality has always been a major challenge for the MENA banks. Non-performing loans have reached alarming levels in many MENA countries due mainly to poor lending practices. In the event of a prolonged slowdown in economic activity, loan quality is expected to worsen further. This may result in a number of banks becoming troubled or even insolvent, requiring the continued use of forbearance if countries are not willing to close problem banks. On the positive side, however, there is little bank dependence on foreign credit lines; banks have little exposure to fluctuations in the prices of equities and other investments; there are virtually no structured credit and derivative products; foreign currency loans are mainly funded from domestic foreign currency deposits and made mainly to exporting corporations. Banks in turn are reasonably resilient to changes in interest and exchange rates.

## *6.7 Prudential Regulation*

As in many countries, the failure of a bank and its liquidation is often viewed as a sign of inadequate regulation and poor supervision. This can put policymakers under serious political pressure. The belief that prudential regulation is sufficient to control bank risk and prevent bank failure is prevalent in many MENA countries. Accordingly, in those countries without deposit insurance some believe there is no need for a deposit insurance system as long as there is a belief that there is a strong supervisory regime in place. Even in the case of a bank failure, priority would be given to resolution methods other than liquidation so as to protect all depositors. The regulatory framework is being improved in many MENA countries to meet the latest international standards and several reform plans were implemented successfully in many countries. Capacity for effective implementation of regulation needs further attention and significant investments are required. For some countries in the region, policymakers believe that stringent rules beyond conventional prudential regulations, such as direct controls on capital movements, foreign exchange transactions and investments abroad, give additional security

against bank failure. This may lessen any perceived need for an explicit, limited deposit insurance system.

## **7. Deposit Insurance in Countries with a Large Presence of State-Owned Banks**

One of the major impediments facing the introduction of explicit limited-coverage deposit insurance systems in certain countries is the large presence of state-owned banks. These banks may create a conflict between the limited deposit insurance systems coverage and the government insurance of deposits held by state-owned banks. In Syria, there is an explicit guarantee, by regulation, for all deposits and other claims on these banks. In Egypt, all deposits have been fully reimbursed in all restructuring or merger cases.

A transition to a limited coverage system would help mitigate moral hazard in these countries. But, situations where private deposits are held by state-owned banks would need to be addressed. In the case of India, for example, both state-owned banks and private banks are subject to the same limited coverage deposit insurance scheme. But as noted in the Core Principles Methodology at footnote 5, where credit and other decisions relating to the operation of a bank are directed by the state it is usually assumed that the deposits in the bank are fully guaranteed by the government.

The Central Bank of Syria is currently considering the adoption of a limited coverage deposit insurance system. Under current arrangements, all deposits held by state-owned banks are explicitly guaranteed by the government, while no guarantee is offered for depositors at private banks (many of them recently established). Despite this situation, the proportion of deposits held in private banks, particularly foreign currency deposits have been increasing in Syria. Private banks are well-capitalized, strongly regulated and viewed as highly credible. They provide competitive interest rates and most importantly offer a wider range of banking products and convenient services to their customers than their state-owned counterparts. Given this experience, it is expected that the adoption of a limited coverage system will improve further the competitive edge for the private banks. It is expected that private banks in Syria could benefit further if both private and state-owned banks were subjected to the same limited level of deposit insurance coverage.

With the continued state ownership of many banks in the country, regulators will need to firmly show their commitment to a limited coverage system. It should not be that the adoption of a limited coverage system leads only to a change from an explicit to an implicit guarantee of deposits in state-owned banks. Instead, there should be the same level of deposit insurance coverage for deposits in state and private owned banks as there is in India.

A deposit insurance system should be able to fulfill its mandate more effectively when operating in a competitive banking environment characterized by a level playing field. That would require an overall reform towards full commercialization which eliminates gradually all preferential treatments and subsidies provided, mostly by regulation, to state-owned banks. Although the reforms might be costly in the short run, they could support many objectives in the long run such as improving the competitiveness of the banking industry and saving public funds. Given the time needed for the reforms it would be helpful for the deposit insurance system to communicate to the public the plan for transitioning to a limited deposit insurance system for both state-owned and private banks.

Other policy choices for countries with a large presence of state-owned banks is to reformulate the role of such state-owned banks if the country wishes to maintain the preferential treatment and subsidies to support certain economic sectors. Under this scenario the role of state-owned banks could be scaled down to specialized financial (lending) institutions that accept specific type of deposits, but do not perform the full range of banking activities. They could be subject to the deposit insurance system as deposit taking institutions but would not compete with banks given their limited mandate. The first solution—reform towards full commercialization—would facilitate and support the privatization process, while the second one—scaling down activities of state-owned banks—would limit their services but keep the basic functions.

A solution with a full range of banking services provided by both private and state-owned banks with preferential treatment to the latter will keep the distortions in the market, increase the cost of government subsidy and hamper the effectiveness of the limited coverage deposit insurance system in containing moral hazard with the deposits held by the state-owned banks enjoying blanket guarantees either explicitly or implicitly.

## **8. Withdrawal of Blanket Guarantees**

Withdrawal of blanket guarantees (both implicit and explicit) is critical for improving the financial resilience of the banking sector in the MENA region. The banking sector is relatively large in most MENA countries. Even amongst the non-oil exporting MENA countries, total assets of the financial sector exceed GDP in many of them and are over 200% in countries like Jordan and Lebanon. Financial system safety and soundness are critically important for policymakers and accordingly confidence must be sustained. The recent history of the region does not reveal any bank failures leading to closure and liquidation. Minor difficulties and liquidity problems were resolved by direct financial support. Large scale problems, however, were resolved either by restructuring or forced mergers. These practices instill in the public the belief that deposits are fully guaranteed by the government, whether there is an explicit blanket guarantee, such as the current temporary guarantees announced in UAE, Kuwait and Jordan, or not. More crucial is that such practices can result in a widespread belief that all deposits are covered in the event of a bank failure

### *8.1 Limited Coverage and Financial Resiliency*

Implicit blanket guarantees, in particular, enable policymakers, in theory, to capitalize on constructive ambiguity. Policymakers believe that such guarantees support system stability with no binding commitment from the authorities. In general, small and large depositors and other classes of creditors have a strong belief that they are protected under the current (implicit) arrangements. Depositors believe they are protected from losses because banks will not be allowed to fail. Accordingly, they have less incentive to access the necessary information to monitor banks. As a result, weak banks with poor lending practices may attract deposits at a lower cost than would otherwise be the case.

However, for market discipline to work effectively, these groups must have the knowledge required to assess the risks they face. Information should be readily available and be generally

understandable by the public. To mitigate moral hazard, there is a clear need for many countries in the region to promote appropriate incentives through good corporate governance and sound risk management of individual banks, effective market discipline and frameworks for strong prudential regulation, supervision and laws. Good corporate governance and sound risk management of individual banks help to ensure that business strategies are consistent with safe and sound operations, and thus can act as the first line of defense against excessive risk taking.<sup>23</sup>

Explicit limited-coverage deposit insurance systems can also promote the resiliency of liquidity risk profiles; an area that requires particular attention in the MENA region compared to systems relying on blanket guarantees. Deposit insurance systems can provide incentives for banks to better manage their risk. The stability of these types of deposits is critical for banks with assets concentrated in loan portfolios. Retail and small deposits tend to be largely stable under the limited coverage system. The recent consultative document on the international framework for liquidity risk measurement, standards and monitoring issued by the Basel Committee has suggested two standards for supervisors to use in liquidity risk supervision.<sup>24</sup> One standard, the Liquidity Coverage Ratio, addresses the sufficiency of a stock of high quality liquid assets to meet short-term liquidity needs under a specified acute stress scenario. The other complementary standard, the Net Stable Funding Ratio, addresses longer-term structural liquidity mismatches. The estimation of both standards requires a clear categorization of deposits according to their stability. Stable deposits can be more clearly defined when the country adopts an explicit limited formal deposit insurance system.

Under current arrangements, policymakers in the MENA region rely mainly on prudential regulatory and supervisory discipline to mitigate moral hazard and control excessive risk taking. Regulatory discipline is mainly exercised through regulations covering the establishment of new banks, the implementation of minimum capital requirements, and adoption of standards for risk management, internal controls, and external audits. Supervisory discipline is also exercised by prompt corrective actions when problems surface, including the closure of banks when necessary, although there is widespread forbearance in the region. Blanket guarantees can create incentive incompatibilities such as the potential for increased use of supervisory forbearance. Thus there is a clear need to introduce more market discipline in the region given the prevalence of poor investment and lending practices and the weak performance of banks in many MENA countries.

The analysis of banks' financial soundness and efficiency suggests that many countries in the region need to improve their banking practices. The chances for improvement would be much higher if policymakers successfully abolish blanket guarantees.

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<sup>23</sup> Good corporate governance and sound risk management includes standards, processes, and systems for ensuring appropriate direction and oversight by directors and senior managers, adequate internal controls and audits, management of risks, the evaluation of bank performance, the alignment of remuneration with appropriate business objectives, and management of capital and liquidity positions.

<sup>24</sup> See BCBS (Dec. 2009c)



## 8.2 Conditions for Effective Transition to Limited Coverage System<sup>25</sup>

International experience overwhelmingly supports the introduction of a credible and well-designed explicit limited deposit insurance system as a means to improve market discipline and help mitigate moral hazard. Uninsured large depositors and other creditors can provide additional sets of eyes to monitor banks. The number of countries adopting explicit limited-coverage systems is increasing. According to the latest IADI survey, by the end of 2009, the total number of schemes in place was 122. Plans are already underway in 5 countries to establish a system in the near future and another 3 countries are studying the introduction of systems.

Given the long history of implicit guarantees in the MENA region, transitioning to an explicit limited-coverage deposit insurance system should be handled carefully. Transitioning can be more successful when the macro economy is fairly stable and the banking system is sound. A deposit insurance system can contribute effectively to the stability of a country's financial system if it is part of a well-designed safety-net. To be credible, a deposit insurance system needs to be properly designed, well implemented and understood by the public. If poorly designed, the system may increase risks (e.g. moral hazard).

IADI guidance on this matter is contained in the “Core Principles for Effective Deposit Insurance Systems” (Core Principle #10).

*When a country decides to transition from a blanket guarantee to a limited coverage deposit insurance system, or to change a given blanket guarantee, the transition should be as rapid as a country's circumstances permit. Blanket guarantees can have a number of adverse effects if retained too long; notably moral hazard. Policymakers should pay particular attention to public attitude and expectations during the transition period.*<sup>26</sup>

Selecting the time to begin transitioning away from blanket guarantees is a delicate issue. Policymakers should conduct a situational analysis to guide the transition process. Among the conditions and factors that must be reviewed in the situational analysis to minimize the risk of instability are: the level of macroeconomic stability, the state and structure of the banking system, supervisory and regulatory infrastructure, public attitudes and expectations, the legal framework, accounting and disclosure regimes.

Where existing conditions and factors are not ideal, it is important to identify gaps and thoroughly evaluate the options available since the establishment of a deposit insurance system is not a remedy for dealing with major deficiencies. If actions are necessary, they can be taken before, or in concert with, the adoption of the deposit insurance system. It is important that policymakers should have specified coverage goals and a detailed timeline for achieving the

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<sup>25</sup> A detailed discussion on transitioning is provided in the Discussion Paper of the FSF Working Group on Deposit Insurance, “Special Considerations when Transitioning from Blanket Guarantees to an Effective, Limited-Coverage Deposit Insurance System,” (2000), p.6 and in the Core Principles Methodology.Principle10 ,

<sup>26</sup> See BCBS/IADI (June 2009)

transition to limited coverage.<sup>27</sup> The conditions for transitioning and the timetable to accomplish them should be identified. The following is a brief discussion of these conditions<sup>28</sup>:

### ***1. Macroeconomic Stability***

Macroeconomic instability hampers the enforcement of market discipline and distorts the whole intermediation function. Banks and their clients have difficulty judging different types of risks in times of deteriorating economic growth, high inflation, and exchange rate volatility. Even when countries suffer macroeconomic structural imbalances in their fiscal or current account positions this can make risk assessment difficult.

The introduction of an explicit limited-coverage deposit insurance system cannot by itself restore macroeconomic stability. As an element of the financial safety-net, deposit insurance complements prudential regulations and the lender of last resort function. During unstable macroeconomic conditions, it may be inappropriate to introduce an explicit deposit insurance system because the low level of public confidence arises mainly from the overall government economic policy and not from concerns about the conditions of the banking system. Conditions and factors that affect the banking system and influence the effectiveness of a deposit insurance system should be analyzed before transitioning and the analysis should include the level of economic activity, current monetary and fiscal policies, inflation and the condition of financial markets.

### ***2. Sound Banking System***

A situational analysis also requires an assessment of the soundness of the banking system, including a detailed evaluation of the condition of capital, liquidity, credit quality, risk-management policies and practices, and the extent of any problems. When problems exist, an assessment should be made as to whether they are confined to individual banks or are systemic in nature.

The number, type and characteristics of banks will have design implications for a deposit insurance system and so the structure of the banking system should be analyzed. Policymakers need to examine the extent of competition, concentration, and the degree of state ownership as well as state direction. The issue of concentration is of growing importance for deposit insurance systems given the globalization of capital markets and financial industry consolidation. For example, in a concentrated system the capacity of a deposit insurance system to fund or cope with the failure of a large and complex bank may be more problematic. When resource distribution and credit decisions are directed mainly by the state, the state is viewed as being responsible for the results of such operations. Deposits in such systems generally are perceived as having a full government guarantee.

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<sup>27</sup> See FSF (Sept. 2001).

<sup>28</sup> FSF working Group on Deposit Insurance, Subgroup Discussion Paper, "Special Considerations When Transitioning from Blanket Guarantees to an Effective, Limited Coverage Deposit Insurance System"(2000), p.6.

### ***3. Reliable Supervisory and Regulatory Infrastructure***

Some of the most important elements needed for an effective transition include a strong system of supervision for insured institutions that provides for early intervention to address emerging problems and a robust legal framework that includes appropriate powers and authorities. These prerequisites are essential for an effective deposit insurance program. A mechanism for resolving failed institutions in a prompt, orderly and cost-effective manner is also necessary. Timely access to the necessary data from insured institutions, accounting and reporting standards that provide adequate transparency, and appropriate coordination among safety-net participants are also important factors in making an effective transition.<sup>29</sup>

### ***4. Conformity with Public Attitudes and Expectations***

Public awareness is critically important for transitioning to limited coverage in the MENA countries. It should be based on a proper analysis of public attitudes and expectations. In the MENA region, there appears to be a gap between the public understanding of the state's responsibilities towards depositors under the longstanding government guarantees and depositors' responsibility under limited coverage systems. The success of systems in enforcing market discipline will depend on depositors' understanding and performance of their responsibilities.

### ***5. Clear Communication and Coordination Plans***

When transitioning, it is particularly important that a transition plan is in place and well communicated to the public. Accurate information should be provided as clearly as possible to all relevant parties, particularly depositors. A public awareness campaign can avoid confusion by the public about the extent to which specific products are covered by deposit insurance. Transparency regarding the specific amounts of coverage, reductions across currently guaranteed products and the associated timelines for reductions will help maintain financial stability.

Gauging the effectiveness of the public awareness campaign is critical; public surveys can help assess whether public awareness is, in fact, enhanced. Any findings to the contrary provide an opportunity to fine-tune the message and target audiences where warranted. Coordination and cooperation among all domestic financial safety-net participants regarding the transition plan and transition timeline are also essential. This recognizes that different safety-net participants have different mandates and may respond to different incentives. A lack of effective coordination among domestic safety-net participants may undermine timely achievement of the transition plan or lead to public confusion.

## **9. Insurability of Shariah-Based Deposits**

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<sup>29</sup> A recent IMF working paper by Hardy and Nieto provides an analysis of the interaction of prudential bank supervision and deposit guarantees in a European context. They find that ongoing integration of European financial markets requires closer coordination of prudential supervision and deposit guarantee regulations. IMF Working Paper 08/283, *Cross-Border Coordination of Prudential Supervision and Deposit Guarantees* (December 2008) at 24.

The insurability of Shariah-based deposits has attracted discussion in many countries in the region given the growing share of Islamic banking.<sup>30</sup> The practice is currently being improved given the practical experiences of many countries and the research contributions that IADI has made in this area. Currently there are three explicit limited deposit insurance systems in the MENA region that adopt mandatory membership for Islamic banks: Bahrain, Sudan, and Yemen.

Bahrain was the first country in the world to establish in 1993 a deposit insurance system for Shariah-based deposits. But as an ex-post funded system it did not raise critical Shariah questions at that time with the system being a form of contribution fund (Takaful) that is clearly permissible under Islamic Shariah teaching. The system is currently under revision by the Central Bank of Bahrain and the main changes include the transformation of the funding system from an ex-post to an ex-ante system with specified limits for two separate funds for the conventional and Shariah-based deposits. The proposed system will insure all types of deposits held by the banks operating in Bahrain including the unrestricted investment accounts or profit-sharing accounts. The changes include an increase of the coverage limit to BD 20,000 (USD 53,000) applicable to all types of deposits and unrestricted investment accounts equally. The new draft law has passed four major reviews by the banks and Shariah scholars and is expected to be formally adopted in the near future.

The Sudanese system, which was established in 1996, introduced ex-ante funding arrangements for insuring different types of Shariah-based deposits including profit-sharing accounts. All deposits in Sudan are based on Shariah principles as non Shariah banking is not permissible in the country. Yemen provides protection for its Shariah-based deposits under a conventional deposit insurance system similar to those in Turkey and Indonesia. Currently, the Malaysian system (established in 2005) is the only dual deposit insurance system that insures both conventional and Shariah-based deposits by a regulation that requires the management of premiums collected in two separate funds. The investments of the fund for Shariah-based deposits are made only in Shariah-compliant investments and the overhead expenses are shared between the two funds.

Deposits held by Islamic banks in Jordan are not insured currently as the deposit insurance system allows for voluntary membership for those banks and none of them have decided to join the system yet. The Jordanian regulations, however, are currently being reviewed with the intention of extending compulsory membership to Islamic banks. This step has become critically important after the licensing of two additional Islamic banks in Jordan which brings the total number of Islamic banks to four. The step is also encouraged with the intention of the government to issue Shariah compliant debt instruments (Sukuk). These changes will enable the deposit insurer in Jordan to practically manage two separate funds for insuring conventional and Shariah-based deposit models similar to the system adopted in Malaysia.

The experience at large reveals that deposit insurance systems are moving towards providing equal insurance to both conventional and Shariah-based deposits. Shariah scholars in Malaysia,

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<sup>30</sup> A summary of an IADI Discussion paper on the permissibility of insuring Shariah-based deposits is given in Annex 1. The paper discusses the arguments of deposit insurance practitioners as to why deposit insurance is permissible by Shariah and the differences between Islamic and conventional deposit insurance systems.

Sudan, and Bahrain accept the permissibility of insuring non-remunerated and profit sharing accounts by third parties subject to the condition that the operations of the system are compliant with Shariah teaching, including the investment of the fund's reserves in Shariah-compliant instruments. It is worth mentioning in this respect that all government blanket guarantees in the MENA region, whether explicit or implicit, cover Shariah-based deposits in addition to conventional deposits.

Shariah authorities (e.g. Board or Committee structures) play an important role in determining the permissibility and the approach Islamic deposit insurance will take. The detailed system design and operations also need to be approved by the relevant Shariah authorities. The basis on which the Shariah scholars have approved the insurability of different types of Shariah-based deposits has been the consideration of public interest or Maslahah, which is an Arabic word meaning “utility, good, beneficial or an advantage”. It relates to the preservation of “faith, life, intellect and property” for people.

The discussion in this respect focuses mainly on the evaluation of the benefits that Shariah-based deposit products will bring to society and which are consistent with Islamic teaching. To be permissible, the deposit insurance system should serve the public interest and must have specific public policy objectives. This same analysis could be used to justify the existence of deposit insurance generally. The public interest is advanced when a system is designed to ensure that no financially unsophisticated depositors lose their money, instill public confidence in the safety of bank deposits, reduce the likelihood of panic among the public, maintain the competitiveness of the Shariah deposits vis-à-vis conventional deposits, preserve public funds, mitigate moral hazard and improve the functioning of the financial sector.

In all countries adopting a deposit insurance system covering Shariah-based deposits, the insurability of the deposits is treated as a third party guarantee that depends on the original contract between the prime parties (depositor and bank). Deposits, according to Islamic teaching, are accepted on the basis of Shariah principles. They are offered under two major Shariah contracts: the safe-keeping or Wadiah (non-remunerated deposits held in current accounts) or the profit/loss-sharing contract that include all types of investment accounts like Murabahah and unrestricted investment accounts. These profit/loss sharing accounts involve the placement of funds made by an investor (account holder) with the bank, which acts as an entrepreneur. The bank invests the funds in Shariah-compliant business activities such as the provision of financing and investment in Sukuk. Any profit from such activities will be shared between the investor and the bank on a pre-agreed profit sharing formula. Any losses will be borne by the investor (depositor in conventional banking terminology); in the case of negligence, mismanagement or any violation of the investment contract the loss will be borne by the bank. The insurance against losses provided by the deposit insurer for such contracts is a third party protection that protects the fund supplier in the event of a bank failure and is not an insurance against the losses related to business or in the normal course of business. Such insurance is supposed to encourage sound investment practices that will contribute to the stability of the financial system and is therefore acceptable under Islamic law.

The profit/loss sharing accounts are classified into two categories: restricted and unrestricted accounts. The draft regulation in Bahrain does not protect the former accounts that are managed separately as off-balance sheet accounts. They are regarded as shared investments by a group of investors including the bank that participates in financing and manages the specified project (also

called a restricted investment). Those who invest in this type of account make their investment in a specific project such as real estate. The investment is managed separately outside the records of the banks (i.e. off-balance sheet). The main risk is project risk and not the bank's risk. There is still a debate going on among the Islamic finance fraternity as to whether the restricted profit/loss sharing accounts should be treated as deposits or investments and whether they should be protected under the deposit insurance system in case of bank failure.

In conclusion, the practice of Islamic deposit insurance is growing and improving. The permissibility of insuring non-remunerated deposits and unrestricted investment accounts that represent a growing portion of bank liabilities is clear. These deposits could be insured by Shariah-based deposit protection arrangements as long as the operations and all features of the system are Shariah compliant. The need for deposit insurance is critical for providing a level playing field for conventional and Islamic banking. The objectives of the deposit insurance system at the macro level (e.g. to maintain financial stability) cannot be achieved unless all depositors enjoy the same protection. This was more apparent in cases where blanket guarantees were adopted by different governments in the region in the aftermath of the global financial crisis.

The implementation of Islamic deposit insurance systems is becoming critically important in the region given the growing share of Islamic banking. Deposit insurance can best contribute to the stability of the financial system through wide coverage of depositors. An inclusive system is needed mainly to complement those MENA financial systems that have already licensed Islamic banks to operate next to conventional banks in order to ensure that the country has a comprehensive financial safety-net.

## **10. Challenges Ahead and the Way Forward**

Many of the countries in the MENA region continue to rely on explicit or implicit blanket guarantees to maintain financial stability. These guarantees are not only costly but also have many negative implications. For example, they can distort resource allocation and create moral hazard. The transition to a limited coverage deposit insurance system poses risks given the longstanding reliance on blanket guarantees. Policymakers in these MENA countries believe that the creation of a limited coverage deposit insurance system will disturb financial stability. The public expect regulators to step in and resolve any systemic or bank specific crisis. These expectations create incentive incompatibilities by rewarding risky banks at the expense of sound ones and thus hampering the advancement of sound industry practices.

The enhancement of market discipline should have the utmost priority given its central role for improving competitiveness and sound banking practices. An orderly plan for creating a competitive banking environment needs to be put in place to support sound practices and allow a gradual reduction in the role of the state.

However, the transition away from the blanket coverage in particular faces serious challenges. The main challenge concerns the need to eliminate the longstanding belief in the MENA region that the government will not let any bank fail. This will require carefully crafted and well communicated plans that might be part of a larger and more comprehensive plan aimed at advancing consumer education. International organizations such as the IMF, the WB and the IADI can help provide the needed support for the development and implementation of plans. The

first stage should be an exploratory exercise analyzing and evaluating experiences around the world in transitioning, the latest developments in exit strategies, potential benefits and costs, along with the basic prerequisites or preconditions that need to be met before transitioning can begin.

The number of countries adopting limited coverage deposit insurance systems has been increasing around the world. The latest revisions to the EU directive on deposit insurance indicate that all member countries should adopt a limited coverage system and specifies the main elements of system design including: coverage limits, fund sufficiency reimbursement, time limits and cross border arrangements. Currently, all industrial economies and major emerging markets either have deposit insurance systems or are contemplating their introduction to protect less financially sophisticated depositors and support financial stability. The latest BCBS discussion paper on liquidity management ties the stability for the sources of funds to the deposit coverage limit. With increasing globalization and the need to integrate international regulatory developments and MENA economies, explicit, limited deposit insurance has become a necessity.

The MENA region should draw on successful experiences in other countries in transitioning to limited coverage deposit insurance systems. However, any transition will need to be managed carefully, taking into account the enormous stresses on markets and institutions that currently prevail.

Among the many challenges facing policymakers are:

- Institutionalized government blanket guarantees are difficult to pull back unless a credible and carefully designed limited deposit insurance system is ready, particularly in the MENA countries that have formally adopted explicit blanket guarantees.
- To be credible, a deposit insurance system needs to be properly designed, well implemented and understood by the public. If poorly designed, the system may increase risks, in particular, moral hazard.
- Transitioning is more successful when the macroeconomic environment is fairly stable and the banking system is sound and healthy. A deposit insurance system can contribute effectively to the stability of a country's financial system if it is part of a well-designed safety-net.
- Cross-border coordination and cooperation in transitioning among countries in the region needs to be enhanced or intensified so as to avoid negative spillovers. The transition process needs to be well coordinated to avoid any potential capital flight and to ensure effective and smooth transition. Existing implicit guarantees in the MENA region have been in place for a long time and the latest explicit guarantees were introduced in individual countries without formal coordination.
- Depositors and depository institutions in the region now expect the introduction of explicit blanket guarantees in any future crisis. This heightens moral hazard and may lead to riskier financial systems unless there is a clear solid commitment for limited coverage systems in the future.
- Differences in income levels and financial structures among MENA economies would eventually lead to differences in the coverage limit, scope and other design elements. However,

the prevailing coverage levels and other central design features in neighboring countries should be taken into consideration by any country considering adoption of or changes to its deposit insurance system given their geographical proximity and deregulated capital movements.

A review of existing systems in other regions indicates the need for reforms in the MENA region. Any reform should be based on the IADI Core Principles which have been formally adopted by the IADI and the BCBS. Reforms would be most effective if all the suggested preconditions in the Core Principles are met.

The reform of existing deposit insurance systems in the MENA countries may not require a complete overhaul as the main design features of the systems are largely in-line with the Core Principles. The critical areas that require attention are mainly: operational independence, governance structure and certain legal aspects. The alignment of authorities granted to the deposit insurer related to both mandates and policy objectives need to be addressed as well. Certain systems need also to reconsider their funding policy and coverage limits.

As for the suggested timing for implementing the reforms, a deposit insurance system is more effective if introduced or reformed during stable economic conditions and after a detailed situational analysis. Conditions and factors that affect the banking system and influence the effectiveness of a deposit insurance system should be analyzed before the introduction or reform of the system. Any analysis should include the level of economic activity, current monetary and fiscal policies, inflation and the condition of financial markets.

If corrective policy measures are necessary, they should be taken before or in concert with the adoption or reform of a deposit insurance system. Situational analysis also requires an assessment of the soundness of the banking system and other deposit taking institutions, including a detailed evaluation of capital adequacy, liquidity, credit quality, risk-management policies and practices, and the extent of any problems. When problems exist, an assessment should be made as to whether they are confined to individual deposit taking institutions or are systemic in nature.

The number, type and characteristics of deposit taking institutions will have design implications for a deposit insurance system and so the structure of the system should be analyzed as well. Policymakers also may need to examine the extent of competition, concentration, and the degree of state ownership as well as state direction. When resource distribution and credit decisions are directed mainly by the state, the state is viewed as being responsible for the results of such operations. Deposits in such systems generally are perceived as having a full government guarantee.

Finally, the sound governance of all agencies comprising the safety-net strengthens the financial systems architecture and contributes directly to the effectiveness of the deposit insurance system. Strong prudential regulation and supervision should allow only viable banks to operate and be members of the deposit insurance system. Banks should be well-capitalized and follow sound-and-prudent risk management, governance and other business practices. The system of prudential regulation and supervision should be in compliance with the Basel Core Principles for Effective Banking Supervision. The regulations should be properly enforced by strong on-site and off-site supervision systems that allow for early detection and intervention to address emerging problems.



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## Annex 1. Permissibility of Insuring Shariah-Based Deposits

The international Association of Deposit Insurers (IADI) has issued Discussion Paper entitled "Deposit Insurance from Shariah Perspective". The paper discusses the arguments of deposit insurance practitioners as to why deposit insurance is permissible by Shariah and the differences between the Islamic and conventional deposit insurance systems. The paper does not provide any opinion with religious approval (Fatwa) from any party authorized to provide such opinions on Islamic deposit insurance but rather provides some of the related Shariah views. The paper also discusses the approaches in designing an Islamic deposit insurance system and takes the readers through the approaches taken by Malaysia and Sudan in developing their Islamic deposit insurance systems.

The paper provided the following views regarding the permissibility of deposit insurance from the Shariah perspective:

In the history of Islam, it was not the intention of the Prophet to rigidly fix the structure of conduct and action for all times, regardless of the change of circumstances. Instead, the Prophet only provided his Companions general guidelines and allowed them to adjust to varied circumstances. The basis of reference has always been the consideration of public interest (*Maslahah*).

*Maslahah*, which is an Arabic word, means utility, good, beneficial or advantage, i.e. something good for the public. It relates to the preservation of faith, life, intellect and property of the human beings.

Deposit insurance contains the element of public interest and therefore, is permissible by Shariah. Such element could be seen in several ways, which could also justify the need for deposit insurance.

Firstly, deposit insurance protects the public from losing their money that they place in a bank when the bank fails. Its implementation is a noble initiative as it prevents the public from facing financial difficulty, especially for those who have limited financial resources. Such difficulty could expose them to social issues. Islam urges its followers to avoid poverty as it could lead them to disobedience to Allah.

Islam always wishes a good and convenient life for every creature without having to face any difficulty. It also urges its followers to prepare themselves in facing any possible disasters, which includes finding means to protect their wealth. As such, the setting up of a deposit insurance system represents Muslims' response to such urge so as to protect their money when a bank fails.

Muslims are also urged to help each other in good deeds. In line with such principle, the Government implemented deposit insurance as an initiative to assist the public in protecting their wealth. Such arrangement may also be set up privately with the same intention of helping the public.

Secondly, deposit insurance could instil the public confidence on the safety of their deposits in the bank. This reduces the likelihood of panic among the depositing public when there is rumour or real occurrence of a bank's failure. The effectiveness of deposit insurance in instilling the

public confidence is evidenced by the establishment of Federal Deposit Insurance Corporation (FDIC) in 1933 as this, to a great extent, helped calmed the Americans about the safety of their deposits in the banks during the Great Depression. This consequently contributed to the recovery of the US financial system.

Undoubtedly, the financial system is the backbone of a country's economy. The banks, among others, make funds available for business entities to start or grow their businesses, which creates employment for the people and contribute to the wealth of the nation. By instilling the public's confidence, deposit insurance could prevent the failure of a bank and contagion effect to the entire financial and economic systems, thus contribute in promoting the financial stability. For Islamic deposit insurance, it could contribute in the same way, especially when the size of the Islamic financial system is dominant and it has integrated well with the overall financial system.

Islamic deposit insurance protects Islamic deposits and therefore, helps maintaining competitiveness of the deposits vis-a-vis the conventional deposits. With this, it could prevent any outflow of the Islamic deposits from the IBIs to the conventional banks and help spur the growth of Islamic deposits and the Islamic financial system.

While deposit insurance is expected to serve the above public interests, the Government should design an arrangement that could work effectively and mitigates moral hazard. Yet, another factor that could influence the permissibility of deposit insurance is the insurability of Islamic deposits. Islamic deposits are accepted by the IBIs based on Shariah principles. They are offered under various Shariah contracts such as safe-keeping (*Wadiah*), loan (*Qqard*), cost-plus (*Murabahah*) and profit-sharing (*Mudharabah*). There is no concern that has been raised on the protection for these deposits except for deposits accepted under profit-sharing contract.

The deposits accepted under profit-sharing contract (known as profit sharing investment account or in short PSIA) are *Mudharabah* placement made by an investor (PSIA holder) with an IBI, who acts as an entrepreneur. The IBI will invest the fund for Shariah-compliant business activities such as provision of financing and investment in Sukuk. Any profit from such activities will be shared between the PSIA holder and the IBI on a pre-agreed profit sharing ratio. Any losses will be borne by the PSIA holder, except in the case of the IBI's mismanagement or negligence, where the loss will be borne by the IBI.

Since the loss will be borne by the PSIA holders, some argued that the PSIA holders should not enjoy such protection. On the other hand, some who assessed the insurability of the PSIA from the facets of other requirements of the profit-sharing contract and public interest (*maslahah*) are of the view that the PSIA holders should be protected based on the following:

- (1) Profit-sharing contract does not allow the IBI to protect the PSIA but protection by third party (e.g. deposit insurer) is allowable;
- (2) The PSIA is only protected in the event of an IBI's failure and not in the normal course of business; and
- (3) The protection for the PSIA will contribute to the stability of the financial system if it has sizable percentage in the financial system.

The PSIA is classified into two categories i.e. restricted and unrestricted PSIA. Some countries may not protect the former as they are regarded as investors (rather than depositors) who

understand well the risk reward relationship of their placement or investment. This is purported to exert market discipline among the restricted PSIA holders when placing or investing their money. On the contrary, the latter may be protected as they behave like depositors (rather than investors). There is still debate going on among the Islamic finance fraternity as to whether the PSIA should be treated as deposit or investment and whether they should be protected under deposit insurance.