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By **Dr. Noor Suhaida Kasri & Mr. Mezbah Uddin Ahmed**

Protection of Investment Account Holders in Islamic Banks in Malaysia:

Legal and Accounting Analysis

Introduction

The Islamic banking industry in Malaysia is governed by the Islamic Financial Services Act 2013 (IFSA). This legislation marks another step in the evolution of the Islamic banking industry in Malaysia. Among its unique components, it re-classifies deposit-taking products into two, namely Islamic deposits and investment accounts. The distinction has brought about a significant impact on the role that Islamic banks have traditionally been playing. The move from purely a credit intermediary to a mixed credit-and-investment intermediary is expected to promote real economic growth and development.

In IFSA, investment account is defined as an account under which money is paid and accepted for the purposes of investment. This must be in accordance with the Shariah on terms that there is no expressed or implied obligation for the Islamic bank to repay the money in full or with any profit. This definition is instrumental as it explicitly distinguishes the character of an investment account from an Islamic deposit account as the latter guarantees return of the capital with or without a profit. This definition embeds statutorily the true spirit of Shariah-compliant investments, namely profit and loss sharing in *musharakah*, profit sharing and loss bearing in *mudarabah* and fee-based in *wakalah bil istithmar*.

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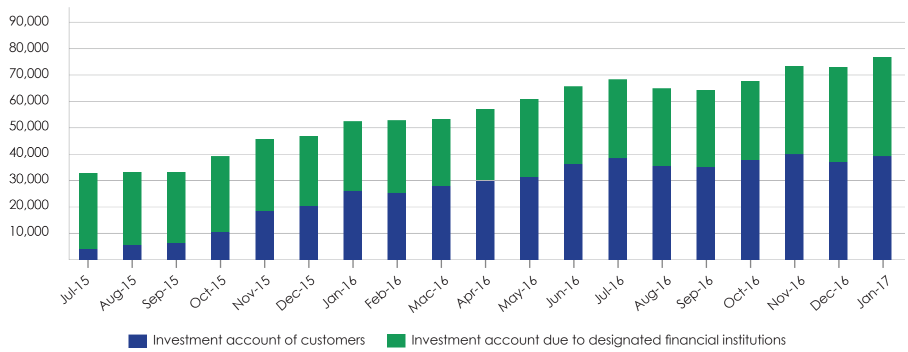
With the features above in mind, it is important to see whether the market has accepted this new breed of banking product; the legal protection the investment account holders have; and how it is reported in the financial statements.

Market Acceptance of Investment Accounts

Though IFSA was promulgated in 2013, the Islamic banking industry in Malaysia was given till middle of 2015 to fully observe the classification and full implementation of the two distinct categories of deposit from their customers. Following this exercise, it was reported that the proportion of investment accounts to total funding for Islamic banks has continued to increase. This indicates a strong and positive response shown by the critical mass for this new product offering.

Beginning 1 July 2015, the entities carrying on Islamic banking activities in Malaysia are required to present separately monies accepted as Islamic deposits and investment accounts. Bank Negara Malaysia (BNM) presents these data in their Monthly Statistical Bulletin. As provided in Figure 1, the data shows an upward trend in investment account balances.

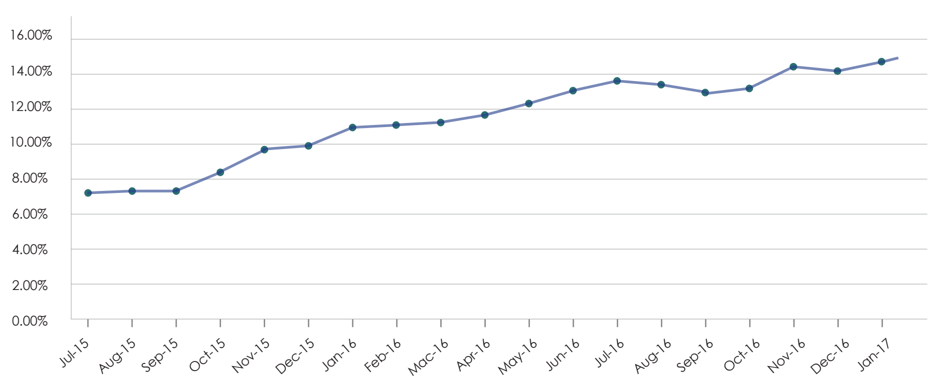
Figure 1: Total Investment Account Balance



Source: Adapted from the Monthly Statistical Bulletin of Bank Negara Malaysia

The data shows that investment account is gaining ground in Malaysia. As of November 2017, the total investment account balance stands at RM 72,448.93 million, which is 12.84% of the total deposits and investment accounts balance. Figure 2 shows that there is an upward trend of total investment account balance not only in terms of volume but also in terms of the share in total deposits and investment accounts balance.

Figure 2: Share of Investment Account in Total Deposits and Investment Accounts



Source: Adapted from the Monthly Statistical Bulletin of Bank Negara Malaysia

The Rights of Investment Account Holders (IAH) From a Legal Perspective

Investment account holders bear the risk of not earning profits as well as losing their capital. However, they are not left orphaned in the regulations. IFSA renders appropriate legal protection to them. This is particularly in the case of liquidation of Islamic banks. To ensure that the legal protection can be implemented effectively, IFSA prescribes for ring-fencing of the assets underlying the investment account. Such mechanism facilitates the payment of liabilities due to investment account holders upon liquidation of Islamic banks. This statutory provision plays a very critical role, especially when the investment accounts capital is not guaranteed as compared to Islamic deposits account. A similar emphasis is given in the policy objectives of the BNM's policy document on *Investment Account* issued on 14 March 2014. One of the policy objectives is to establish strong oversight arrangement and sound risk management infrastructure in the management of investment accounts to safeguard the interest of the IAH and other stakeholders.

In the winding up of a licensed Islamic bank, whether it is based in Malaysia or overseas, Section 217 of IFSA describes the chronological flow of the payment structure. In such an event, the investment account holders will receive the monies owed to them that will be taken from the realization of the assets underlying their accounts.

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The distribution will be made in the following chronological payment order:

(i) to pay the costs and expenses of the winding up that are directly incurred in the realization of the assets of such investment accounts;

(ii) to pay the relevant tax attributable to the investment accounts;

(iii) to pay the outstanding costs or expenses of the investment accounts;

(iv) to pay any profit, fees, gains or other remuneration due to the licensed Islamic bank; and

(v) to meet the liabilities to the investment account holders.

A similar provision is also provided in a new regulation, the *Malaysia Deposit Insurance Corporation (Order of Priority for Payments of Different Categories of Islamic Deposits, Determination and Classification of Assets and Application of Disposal Proceeds of Assets in the Winding Up of Deposit-taking Member)* Regulations 2017, issued on 19 April 2017.

It is observed that the above treatment given to investment account holders differ with that of Islamic deposit holders. In IFSA, which entitled the deposited amount to be guaranteed, the Islamic deposits are given priority in the winding-up claims of Islamic bank from the assets of the Islamic banks (preferential debts are also given similar priority treatment). Despite the difference in the level of priority given to investment account holders, what is explicit is the legal backing given in protecting the rights of the investment holders by ring-fencing their asset claims. This legal backing is needed as it would give the needed trust and confidence of the investment account holders to the Islamic banks. From the industry perspective, it provides the right seed to grow and sustain this new asset class in the Islamic banking industry in Malaysia.

Financial Reporting of Investment Accounts

The academics, industry practitioners and professional accountants have discussed the financial reporting issues of investment accounts at great length. The discussion on recognition, measurement, presentation and disclosures of investment accounts continues, and differences of opinion are still visible on different fronts. Nevertheless, for financial reporting purposes, the investment accounts are classified into two types: restricted investment accounts (RIA) and unrestricted investment accounts (URIA). The differentiation is made primarily depending on the control over the money received in the investment account. In RIA, the investment account holder dictates use and deployment of the money, i.e., they retain the control. Hence, this is treated as an off-balance sheet item in financial reporting of the Islamic bank. In URIA, the Islamic bank has control over the money received as to where and how to invest, hence this is treated as an on-balance sheet item. Having said that, a careful examination of the individual investment account terms and conditions need to be performed in deciding whether it shall be an on/off-balance sheet item in light of International Financial Reporting Standards (IFRS) requirements.

The BNM Guidelines on Financial Reporting for Islamic Banking Institutions require the Islamic banks to present carrying amount and income and expenses related to Islamic deposits and investment accounts (i.e., URIA) in separate line items. The carrying amount of URIA is presented under liabilities and the carrying amount of RIA is presented as an off-balance sheet item separately from other commitments and contingencies. The specific requirements on separate presentation in financial reporting not only show the importance of investment accounts but also keep the users of financial statements informed of the balance that belongs to a specific group, which is the investment account holders. The liability classification also emphasises that the balance belongs to them only, not to the Islamic bank.

The introduction of investment accounting IFSA and differentiating it from the traditional deposits account is an enabler for the banks to operate within a risk-sharing financial ecosystem.

Conclusion

The introduction of investment account in IFSA and differentiating it from the traditional deposits account is an enabler for the banks to operate within a risk-sharing financial ecosystem. It facilitates new avenues of financial innovation and bolsters real economic activities. For instance, this is demonstrated in the combining of the investment account concept with a bank-intermediated financial technology (fintech) platform known as the Investment Account Platform (IAP) (launched in February 2016). This platform channels funds from investors to viable economic ventures.

IFSA provides appropriate legal protection for the investment account holders while ensuring financial stability in the Islamic financial system. Attention should be given in good governance of the investment account management and appropriate disclosures on its performance so that customers' confidence can be attracted and retained. IIFS