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Impacts of the Islamic Financial Services Act 2013 on Investment Account products offered by Islamic Banks in Malaysia

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Abstract
The Islamic Financial Services Act (IFSA) 2013 is a Malaysian banking law which was enacted to regulate and supervise the banking practices of Islamic finance institutions. IFSA 2013 has the effect of repealing the Islamic Banking Act 1983 (IBA), the Takaful Act 1984, the Payment System Act 2003 and the Exchange Control Act 1953. Prior to the introduction of IFSA 2013 there was no clear distinction between deposit and investment accounts. The IFSA 2013 re-defines Islamic deposit, and classifies investment accounts as non-principal guaranteed while deposit account as principal guaranteed. The objective of this paper is thus to explore implications of IFSA 2013 on investment accounts from the perspective of the banker. Future research could explore the perspective of account holders looking at their views on investment accounts and IFSA 2013.

Keywords: Investment Account; Deposit Account; Islamic Financial Services Act; IFSA 2013; Islamic Bank; Malaysia

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1. Introduction

The rise of the Islamic banking and finance sector has lead to growing concern about diligence of Shariah compliance at Islamic financial institutions. Managing assets and offering financial products in accordance with Islamic principles is more complicated than conventional banking because of the unique features of avoiding exploitative or unfair banking practices of any kind. Compliance with Shariah principles is a continuous process to ensure that all operational activities and financial products do not violate Shariah rulings and resolutions published by authoritative bodies. The central bank of Malaysia, Bank Negara Malaysia, has made tremendous efforts in promoting Shariah governance. These include the establishment of the Shariah Advisory Council as the highest Shariah authority in Islamic finance in Malaysia and also the introduction of the Shariah Governance Framework in 2010 and a policy document on Shariah Governance in 2019.

Malaysia operates a dual financial system; an Islamic finance system operates alongside the conventional financial system. The legal framework of Malaysia is divided into two; regulatory law and law on transactions. In the context of Islamic banking and finance, the enabling law provides provisions that enable the operation of Islamic banking and takaful, such as the Islamic Financial Services Act 2013 (IFSA), the Central Bank of Malaysia Act (CBMA) 2009, the Government Funding Act 1983 and the Development Financial Institution Act 2002. The laws on transactions on the other hand, refer to the nature of the contract that allows the operations of Islamic banking and takaful institutions that offer Islamic finance facilities to customers. Some examples include the Hire Purchase Act (1967), the Rules of Court (2012), the Stamp Act (1949) and the Sales of Goods Act (1979) among others.

In 2013, the Islamic Financial Services Act (IFSA) 2013 was introduced. The Act was enacted to provide for the regulation and supervision of Islamic financial institutions and oversight of the Islamic capital market to promote Shariah compliance and financial stability. It consists of 18 Parts containing 291 sections and 16 schedules, and it emphasises four key dimensions, namely: a Shariah governance framework; Shariah standards for each Islamic financial product; pre-emptive measures to address issues that may affect the interests of depositors and policyholders; and lastly, the effective functioning of Islamic financial mediation (Laldin and Furqani, 2018).

This paper aims to explore the implications of IFSA 2013 for investment accounts offered by Islamic financial institutions in Malaysia, by exploring the perspective of Islamic bankers and also examining relevant guidelines and policy documents issued by Bank Negara Malaysia. This paper is structured as follows: the first section introduces the Legal Framework of Islamic Finance in Malaysia followed by the Investment account products offered by Islamic banks. Next, the research methodology of this paper is presented, followed by the findings before presenting conclusions.

2. Islamic Financial Services Act 2013 and Investment Account

The Islamic Financial Services Act 2013 (IFSA) was published in the Government Gazette on 22nd of March 2013. This legislation particularly provides for the implementation of the risk of non-compliance with Shariah principles and imposes legal duties on Islamic financial institutions to ensure that their objectives, operations and business activities comply with Shariah principles. IFSA was a recommendation of the Financial Sector Blueprint 2011-2020 issued by Bank Negara Malaysia (BNM). With the establishment of IFSA 2013, the Islamic Banking Act 1983, the Takaful Act 1984, the payment System Act 2003 and the Exchange Control Act 1953 are repealed. IFSA 2013 combined and updated the individual Acts, Islamic Banking Act (1983) and Takaful Act (1984) into one Act.

Theoretically, the introduction of Investment accounts by IFSA 2013 should allow more room for Islamic financial institutions to use true sale credit financing instruments (Rosly, 2017). The Act also allows a greater level of flexibility in terms of investment criteria (Engku Ali and Oseni, 2017). Islamic financial institutions are expected to introduce a new structure for investment accounts, which reflects the actual performance of the underlying asset or business activity (Hasan, 2016). Prior to IFSA, Islamic banks did not clearly differentiate between risk-sharing and risk-transfer activities. Murabahah investment accounts, for instance, were ambiguously treated as deposits and liabilities (Alaeddin et al., 2016). As ownership risk from credit sale contracts is absorbed by the investment account holders, Islamic banks should be relieved from the unwarranted stress on capital and the shareholders in turn, could be free from the stress of high capital charges (Rosly, 2017). The challenges and associated costs for Islamic financial institutions in meeting regulatory changes are substantial because they need to revise their product offerings and adopt risk-sharing instruments that can be traded in capital markets. However, the Act may cause unintended consequences for investment account holders, such as lower profit payout and "withdrawal risk" (Archer et al., 2010) where investment accountholder withdraw their funds and switch to other financial products. The Act makes Islamic financial contracts like Mudharabah (partnership) unsuitable for deposit accounts because of their non-guaranteed principal nature (Ahmad et al., 2017).

Under IFSA 2013, Islamic banks are required to separate the funds placed by customers into Islamic deposit and investment accounts. While the deposit account is principal-guaranteed hence risk-free; the investment account is subject to potential loss because it is not protected or guaranteed. The clearly defined investment account given by IFSA 2013 represents a shift towards a risk sharing model. Prior to this precise distinction, the difference between investment accounts and deposit accounts were not clear both in substance or form (Alaeddin et al., 2016). Moreover, Islamic deposits are confined to principal guaranteed by Shariah contracts such as Qard, Wadiah and Murabahah whilst the Investment Account is structured based on Mudharabah, Musharakah and Wakalah contracts that do not provide guarantee of the return of principal nor a profit on investment.

Based on IFSA 2013 section 2 (1), "Investment account" refers to an account into which money is paid and accepted for the purpose of investment, including for the provision of finance, in accordance with Shariah principles. There is no obligation for the bank to repay the money in full and the account holder may not receive any return; profits and losses are shared between the account holder and bank. IFSA 2013 Section 2 (1) defined "Islamic deposit" as a sum of money accepted or paid in accordance with

Shariah principles. The account holder is not subject to financial loss and the principal amount will be repaid in full either on demand or at a time agreed by both parties.

2.1. Changes to Islamic banking regulation in Malaysia

IFSA 2013 repealed existing banking regulations on Islamic banking and finance and it also revised the accounting standards under which Islamic financial institutions prepare their accounts. Some of the main changes are as follows:

1. Product Disclosure Sheet (PDS)
2. Principal Guaranteed and Profit Smoothing Practices
3. Financial risk management
4. Financial reporting
5. Rate of Return Framework

First, the product disclosure sheet for investment account products was not sufficiently detailed for the financial consumers and potential investors to make informed decisions. Prior to IFSA 2013, the product disclosure sheet has little or no information on risks involved, product suitability, investment strategy, historical performance, possible outcome of investment, indicative rate and profit calculation. Financial consumers should be informed or warned against any potential risk before investing. On top of that, the difference between deposit and investment accounts was not clear (Alaeddin et al., 2016). In 2014, Bank Negara Malaysia issued a policy document on investment accounts which aims to outline the regulatory requirements on the conduct of investment accounts under the IFSA 2013. One of the main requirements is to clearly disclose the product structuring of the investment account, including sources of funding, investment objective, profit distribution and agency fee, investment tenure, valuation methodology, and terms of termination.

Second, profit smoothing practices play an important part in ensuring stable returns for account holders in both conventional and Islamic banking. In the past, both deposit and investment account holders were protected by with-principal guarantees. Under IFSA 2013, Islamic banks are not allowed to use profit smoothing techniques. Magalhães and Al-Saad (2013, p. 44) criticised profit smoothing techniques such as profit equalization reserve; "*practices impede the transparency and reliability of financial information, and severely constrain the investors from evaluating the bank's actual performance*". On top of that, there has been a lack of consistency in referring to the investment account because it is sometimes reported as equity or as liability in other instances (Magalhães and Al-Saad, 2013). Under IFSA 2013, banks must also redefine capital risks and valuation risks, in addition to meeting liquidity requirements and also risk objectives. This naturally leads to the third issue: financial risk management.

IFSA 2013 recognises the importance of Shariah non-compliance risk and it specifies legal consequences for breaching Shariah principles. Section 28 (5) states that: "*Any person who contravenes subsection (1) or (3) commits an offence and shall, on conviction, be liable to imprisonment for a term not exceeding eight years or to a fine not exceeding twenty-five million ringgit or to both*". Subsection 1 revolves around the significance of Shariah compliance while subsection 3 suggests remedial measures to manage Shariah-non compliance risk. Section 28 (3) states that any activity which is not in compliance with Shariah needs to be ceased immediately and notified to the bank and Shariah Committee within thirty days.

Financial reporting is another change that Islamic financial institutions need to undertake under IFSA 2013. One of the main purposes of IFSA 2013 is to add transparency and enhance Shariah compliance (Laldin and Furqani, 2018). Alaeddin et al. (2016, p. 16) pointed out that the balance sheet structure of Islamic banks is "characterised by a profound asset-liability mismatch". Alaeddin et al. (2016) argued that such mismatch exposes the banks to a vicious cycle of liquidity gaps, hence the need for credit facilities with the central bank. Financial reporting plays an integral part in corporate governance and Shariah compliance. In reference to the policy document on investment accounts issued by Bank Negara Malaysia (2014), Islamic financial institutions must disclose the following in their annual financial statements: accounting policy, movement of funds, average profit sharing ratio, declared rate of return to investment account holders, agency fee and performance incentive fee. Islamic financial institutions are bound by regulations to differentiate investment accounts from other type of deposits and to report investment accounts as separate items from the owner's equity and liabilities (Ahmed et al., 2019).

Lastly, there is strong emphasis on the treatment and distribution of profit in the Rate of Return to investment accountholders, together with the performance report, distribution tables and warning disclaimers requirements. The policy document on investment accounts issued by Bank Negara Malaysia in 2014 states that: "*Under the IFSA, the priority of payment for investment account upon liquidation of the Islamic financial institution is treated separately from Islamic deposit*" (Bank Negara Malaysia, 2014, p. 1). Prior to IFSA 2013, all deposits collected from deposit and investment account go into a common pool of funds for investment. The expected return was computed as a simple time-series average of monthly rates of return. Under IFSA 2013, the return on the investment account is based on actual performance of the underlying assets and thus subject to financial losses and market uncertainty.

Table 1: Before and after IFSA 2013 was introduced

	Pre-IFSA 2013	**Post-IFSA 2013**
Principal	Principal guaranteed	Principal amount is not guaranteed
Profit smoothing	Application of profit smoothing techniques were allowed	Profit smoothing techniques are not allowed
Disclaimer	No specification on disclaimer	Disclaimer and warning statement must be given to financial consumers with regards to likely risks involved
Financial risk management	No clear guidance on managing financial risk and Shariah-non compliance risk	Remedial measures are suggested
Financial reporting	No clear guidance on financial reporting	Robust and sound financial reporting must be provided
Rate of Return Framework	Rate of return was predetermined	Rate of return is subject to actual performance of the underlying assets

Table 1 summarises the differences in investment accounts before and after IFSA was introduced.

2.2. Investment accounts in compliance with IFSA 2013

There are two types of investment account offered by Islamic banks in Malaysia; restricted investment accounts (RIA) and unrestricted investment accounts (URIA). URIA is a type of investment account in which the accountholder provides the Bank with a mandate to make investment decisions without specifying restrictions or conditions. Typically, a URIA is structured under Wakalah and Mudharabah contracts. RIA, on the other hand, is a type of investment account where the accountholder specifies investment parameters, such as assets utilisation and investment tenure.

The policy document on investment accounts issued by Bank Negara Malaysia (2014, p. 5) noted that: “The Islamic financial institutions must ensure that the investment account is structured based on the application of Shariah contract(s), including such arrangement which does not create an obligation on the Islamic financial institutions to repay in full, the money accepted from the investment accountholder, e.g. Mudharabah, Musharakah or Wakalah”. This section reviews the nature and modus operandi of investment account under the Islamic contracts of Mudharabah, Musharakah, and Wakalah.

2.2.1. Mudharabah Investment Account

The Mudharabah (profit sharing and loss bearing) investment account is a financial product in which the accountholder authorises the Islamic bank to administer or manage funds, the bank in turn, invests in Shariah compliant businesses (Abdul Manap et al. 2017). This product has maturity periods, ranging from overnight to up to twelve months. Like other Shariah compliant financial products, an interest rate is strictly prohibited and the accountholders share the profits that accrue from the transaction with the bank, based on an agreed profit sharing ratio (Bank Negara Malaysia, 2014). Any loss will only be borne by the customer as the sole capital provider (Abdul Manap et al. 2017).

2.2.2. Musharakah Investment Account

Musharakah is a partnership agreement. According to Bank Negara Malaysia (2014), the share of profit or loss between the accountholder and the bank is based on the agreed profit sharing ratio in a Musharakah investment account. Unlike Mudharabah, accountholders share any losses with the bank (Abdul Manap et al. 2017).

2.2.3. Wakalah Investment Account

Wakalah (agency) is a contractual relationship executed between two parties, one providing the capital and the other acting on behalf of the capital provider to invest in a pre-determined activity. In this arrangement, investors (as Muwakkil) entrust the bank (as Wakeel) to manage the money they put in investment account. The bank receives agency fees regardless of the performance of the investment account. According to Bank Negara Malaysia (2014), the profit is distributed to the accountholder after deducting the agency fee and agreed performance incentive fee (if any) to the bank.

Table 2 summarises the key features and differences of these three investment accounts.

Table 2: Differences between Mudharabah, Musharakah and Wakalah investment accounts

	Mudharabah	Musharakah	Wakalah
Profit distribution	Profits are shared between investors and bank according to agreed ratio	Profits are shared between investors and bank according to agreed ratio	Profits are distributed to investors after deducting agency fee
Loss distribution	Losses are borne by investors	Losses are borne based on proportion of capital contributed	Losses are borne by investors
Contractual relationship	Manager and capital provider	Partners	Agent and capital provider

2.2.3. Investment Account Platform

Introduced in 2016, the Investment Account Platform (www.iaplatform.com) serves as a centralised multi-bank platform regulated by IFSA supervised by Bank Negara Malaysia. This platform is a joint effort of six different Islamic banks enabling investors to view and select from a wide range of ventures and also invest and track their investments. Similar to the concept of crowdfunding, the platform collects capital from multiple investors to fund ventures (Kasri and Muhammad, 2019). The platform provides an avenue where investments from restricted investment accounts will be matched with ventures in Malaysia through an online platform supported and mediated by six participating banks (Engku Ali and Oseni, 2017). The contractual relationships of investors, sponsoring banks and entrepreneurs are structured according to the Shariah principles on profit and risk sharing. Fees applicable to investors are contingent upon the type of Shariah contract in the investment account: Mudharabah, Musharakah or Wakalah. Potential investors must undertake a suitability assessment as part of risk profiling, while the entrepreneur or project must disclose information about the venture for assessment. The rating of the venture or project is performed by a credit rating agency. Most small and medium enterprises are not aware of the availability of Islamic business financing facilities and the Investment Account Platform (Husin and Aziz, 2019).

3. Research Methodology

To accomplish the research aim, a qualitative research methodology was adopted. The questionnaire consists of eight open-ended questions which focus on investment accounts and IFSA 2013. No demographic questions were included in the questionnaire. This research draws a small snowball sample because it is most suitable where an identifiable population is not readily available (Dantzker and Hunter, 2011). Relying on referrals from the participants to identify prospective units for sample, this research collected data from practitioners working in Islamic banks in Malaysia. Three banking professionals participated in this research because of the difficulty in finding competent respondents with in-depth knowledge of the subject. Using referrals or personal connections of the first respondent as a means of gaining access to other members of the population raises concern about external validity (David and Sutton, 2004), which is another research limitation of this paper besides relatively small sample.

4. Results and Discussion

Data from the questionnaire show that the introduction of IFSA 2013 is crucial to the growth and development of Islamic finance industry in Malaysia.

One respondent commented:

> Prior to the implementation of IFSA, the Islamic banking industry can be considered to be still young and have yet to mature. I believe this is not a good excuse for them to not abide to the Shariah Principles. However, I understand that Islamic Banking is following the Conventional approach at first before IFSA comes into the picture of legislation. Thus with the establishment of IFSA, it helps bankers to demarcate to operate their business according to the principles.

In a similar vein, another participant stated:

> The industry was competing against conventional finance to entice the market into Islamic finance. The number of institutions offering Islamic solutions were small as compared to conventional hence there was a need to establish a “mirror” system that could meet expectations. As well prior to IFSA, the market was not confident with Shariah solutions due to lack of awareness and education. Establishing new thing is not an overnight task, it requires time.

Based on the comments about product disclosure sheets, it appears that most research participants believe that the emphasis on product disclosure and disclaimer statement is necessary to protect financial consumers. One respondent thinks that the degree of product awareness depends on the competency of banking professionals and salespeople:

> Depends. If the staff truly understand the product and the customer reads everything prior entering into the contract. Because usually the customer would like to know the benefit that they could gain from the products.

Research participants have different opinions regarding profit smoothing techniques such as Profit Equalization Reserve (PER), with one being sceptical about the prohibition of PER, one observing that some banks stopped using PER prior to introduction of IFSA 2013 and one firmly believing that PER should not be used in investment accounts in order to comply with Shariah principles of risk sharing.

A common consensus among the research participants is on the risky nature of investment accounts and thus that the principal amount is not guaranteed. One commented: “Because there are no guarantees when it comes to investment. If it is guaranteed it should fall under deposits”.

The research participants share similar views regarding Shariah non-compliance; that Islamic financial institutions should face legal consequences in the event of violating

Shariah principles; however, they did not indicate which kind of legal consequences they deemed appropriate.

When asked about their views regarding the implications of IFSA 2013 for the product structuring of investment accounts, most research participants consider that regulatory change is necessary for the development of Islamic banking and finance sector. One said: "Shariah is required to ensure the operations of investment accounts are in adherence with BNM requirements. Legal has to establish holistic documents that would support the operations of the IA. Supervision on the IA is strengthening". Another respondent echoed: "From a Shariah perspective, it has strengthened Shariah compliance. From a legal view, it has increased public confidence toward the Islamic finance system". Similarly, another research participant stated: "the Islamic banks are being forced (in a good way) to follow the rules established".

With regard to the reactions of financial consumers to regulatory changes, research participants noted that some customers are confident with their fund managers managing their wealth, while others transferred their funds from investment accounts to deposit accounts after IFSA 2013 came into effect. One commented that customers transferred their funds "because they would feel unsecure [without the principal guaranteed]".

The main findings that have emerged from this paper are as follows. First, the introduction of IFSA 2013 brings positive impacts for banking professionals working in Islamic banks. They consider it to be a way forward for the Islamic finance industry in Malaysia. Second, it is necessary to distinguish investment accounts and deposit accounts in order to offer a variety of financial products to meet customer needs. Customers are now given a wider range of alternatives when managing their personal wealth. Third, a clear product disclosure statement increases product awareness. A significant part of IFSA 2013 is about financial consumer protection and the product disclosure statement provides a summary of the key information relating to the product thereby promoting greater transparency and disclosure.

5. Conclusion

The establishment of IFSA 2013 has had a major impact towards Islamic banks reclassifying their Islamic deposit accounts and investment accounts. However, regulators have been very supportive in publishing relevant guidelines and giving a two year transition period. This transition period was given to ensure the effectiveness of the transition process and to allow financial consumers to make informed investment decisions. Islamic banks face challenges, not just in revising or redesigning their financial products, but also in reporting, auditing and ensuring Shariah compliance in their business operations. Moving forward, industry players and financial consumers play an important role in developing a sound and sustainable Islamic financial ecosystem. IFSA provides a legal basis to further support the development of the operation of investment accounts and to provide financial consumer protection to investment account holders whilst ensuring financial stability of the Islamic finance ecosystem. The Act promotes a risk-sharing model for investment accounts (Alaeddin et al., 2016) and makes clear the legal consequences of violating Shariah principles.

One major research limitation of this paper is the sample. This research focuses on the perspective of bankers and Shariah officers regarding IFSA 2013 and its implications on investment account. It would be fruitful to understand the views of the investment account holder, especially before and after the transition period. In particular, it would be worthwhile to investigate their awareness of the legal consequences in the event of Shariah non-compliance and of financial consumer protection relating to misconduct in banking practice.

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