

Investment Accounts under IFSA

Islamic finance, through its diverse spectrum of Shariah contracts, is well positioned to serve the real economy and fulfil the dynamic needs of customers. The introduction of investment accounts by Islamic banks is an important step forward in fulfilling this potential. These accounts offer new investment avenues that can cater to a wider range of investor risk-return preferences, thereby further contributing to the financing of entrepreneurship in the real economy. For Islamic banks, investment accounts will open up opportunities to tap new sources of funding that can be efficiently channelled to productive activities through the broader application of Shariah contracts such as equity-based contracts. This in turn will broaden the financial intermediary role of Islamic banks in promoting economic growth and development.

This article provides an overview of the key concepts and features of investment accounts, the implications for customers and Islamic banks, and steps taken by the Islamic banking industry to provide an efficient mechanism for delivering investment account products in the market.

Investment Account as a New Product Offering for Customers

The clear distinction between investment and deposit accounts under the Islamic Financial Services Act 2013 (IFSA) paves the way for the accelerated growth of investment accounts as a distinct Shariah-compliant asset class and source of funding for Islamic banks. Customers with higher risk appetites will have the option of placing their surplus funds in investment account. Unlike Islamic deposits which can be withdrawn on demand and guaranteed by Perbadanan Insurans Deposit Malaysia (PIDM), clients of investment accounts are able to retain funds for a longer period of time and enjoy the opportunity to earn more returns but with more restrictive withdrawal conditions.

Investment accounts can be structured with different risk and return profiles that vary in accordance with the characteristics of the underlying assets. The funds sourced for these accounts can be directed to diverse forms of financing that extend beyond debt-based to include equity-based financing, as well as funding to viable ventures under a broader set of credit criteria (e.g. higher concentration limits) that are aligned with the risk-absorbing features of investment accounts. In terms of asset types, the funds can be channelled to a targeted asset such as trade financing to an individual exporter, or a portfolio of assets such as financing for a group of small and medium enterprises.

Investment accounts are an additional avenue, complementing private equity and venture capital funds, for businesses to access financing. The level of returns generated depends on the performance of the underlying asset, with possible upside potential in returns to customers generated from equity-based financing structures as well as more efficient capital and liquidity management strategies by Islamic banks. The form of the returns on investment accounts is governed by the types of Shariah contract adopted. These contracts generally fall under the following categories:

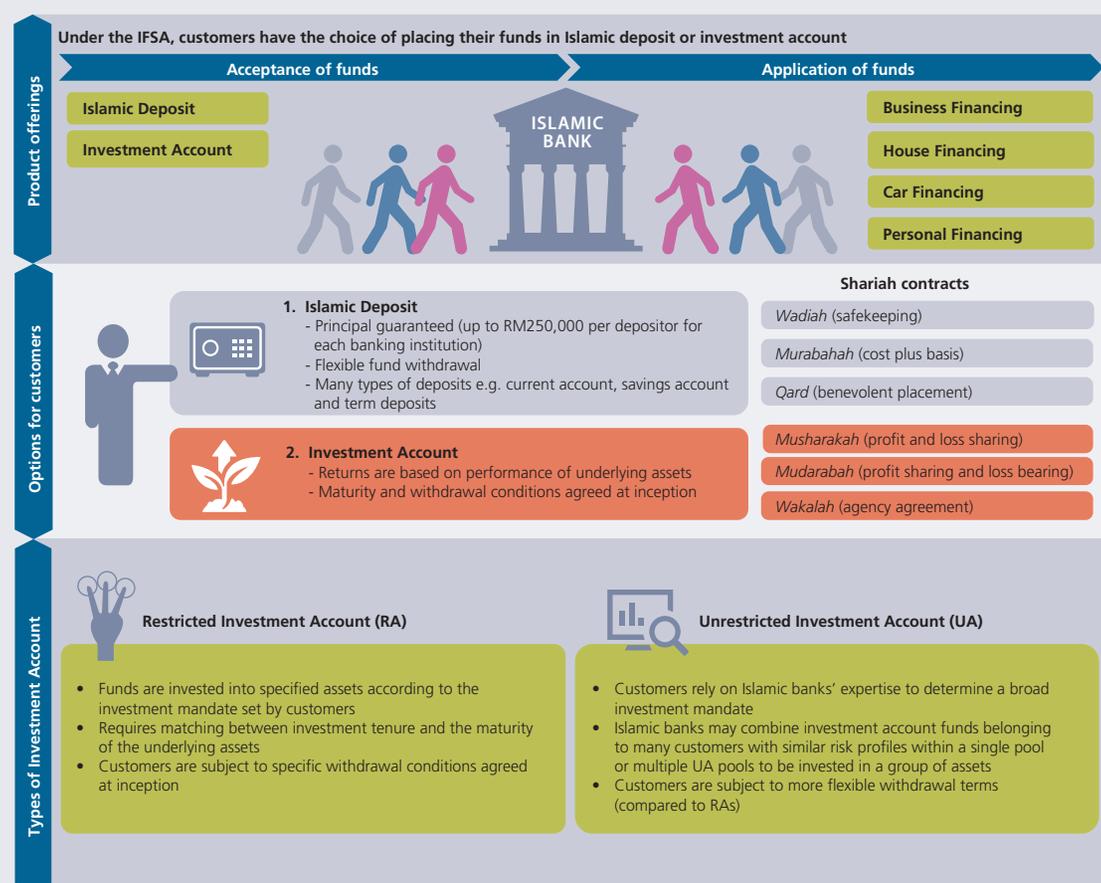
- *Musharakah* (profit and loss sharing) contracts - where profits are shared between the customer and the Islamic bank according to an agreed ratio and losses are borne based on proportion of capital contributed;
- *Mudarabah* (profit sharing and loss bearing) contracts - where profits are shared between the customer and the Islamic bank according to an agreed profit ratio and losses are fully borne by the customers as the sole capital providers; or
- *Wakalah* (agency) contracts - where profits are returned to the customers after payment of agency fees (imposed upon placement of principal or generation of returns) and performance fees when returns outperform an agreed benchmark.

Two main types of investment accounts are offered by Islamic banks in Malaysia: restricted and unrestricted investment accounts. Restricted investment accounts (RA) enable customers to specify the investment mandate and the underlying assets that their funds may be invested in. Consistent with the

more restrictive investment parameters, the maturity of a RA must match the tenure of the specified underlying assets with more restrictions imposed on the ability of account holders to withdraw their funds before maturity. Unrestricted investment accounts (UA), on the other hand, allow Islamic banks to determine the investment mandate and the structure of the investment account, which may include combining different UAs into pools of funds that invest in diversified portfolios of underlying assets, in exchange for more flexible withdrawal conditions. While investment accounts can be tailored to meet a diverse range of customer needs and preferences, they do not enjoy the guarantee of principal by PIDM. Under the IFSA, these important distinctions between UAs, RAs and deposit accounts must be reflected in an Islamic bank's operations as well as in its dealings with customers. Diagram 1 illustrates the key product offerings by Islamic banks.

Diagram 1

Main Product Offerings by Islamic Banks



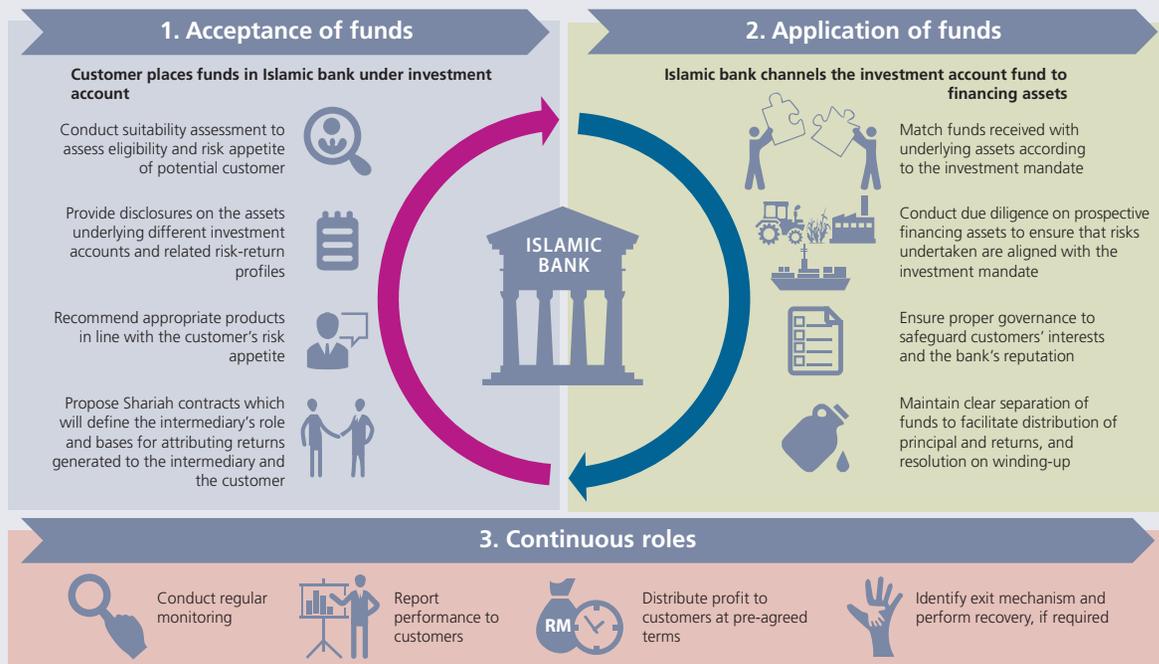
Operationalisation of Investment Accounts by Islamic Banks

The operationalisation of investment accounts is governed by the policy document on investment accounts which was issued by the Bank in March 2014. The document sets out the capital adequacy and liquidity requirements for investment accounts that reflect their risk-absorbing characteristics, additional disclosure requirements commensurate with the risks assumed by account holders, and responsibilities of Islamic banks to manage the investments in accordance with sound investment principles. The IFSA further safeguards the interests of investment account holders by according priority to the claims of account holders on the underlying assets funded

by investment accounts in the event of a winding-up procedure. Specifically, the Act provides that the assets underlying investment accounts shall be ring-fenced for the purpose of meeting the claims of investment account holders. An overview on the operationalisation of investment accounts is provided in Diagram 2.

Diagram 2

Intermediation Functions of Islamic Banks in Operationalising an Investment Account



Investment Account Platform to Enable the Efficient Delivery of Investment Account Offerings

A key strategy to achieve critical mass and provide the widest possible coverage of prospective investment ventures and sponsoring institutions is to leverage on shared infrastructure for the delivery of investment account offerings. This would significantly reduce initial investment costs that would otherwise be incurred by individual Islamic banks, while laying the groundwork for further efficiency gains to be reaped in future. The Investment Account Platform, which will be developed by the industry, will serve as a centralised multi-bank platform that will allow customers to view and choose from a wide range of ventures sponsored by different Islamic banks for the customers to invest and track their investments. The platform, which will operate on a secured infrastructure similar to internet and mobile banking, will have the following innovative features:

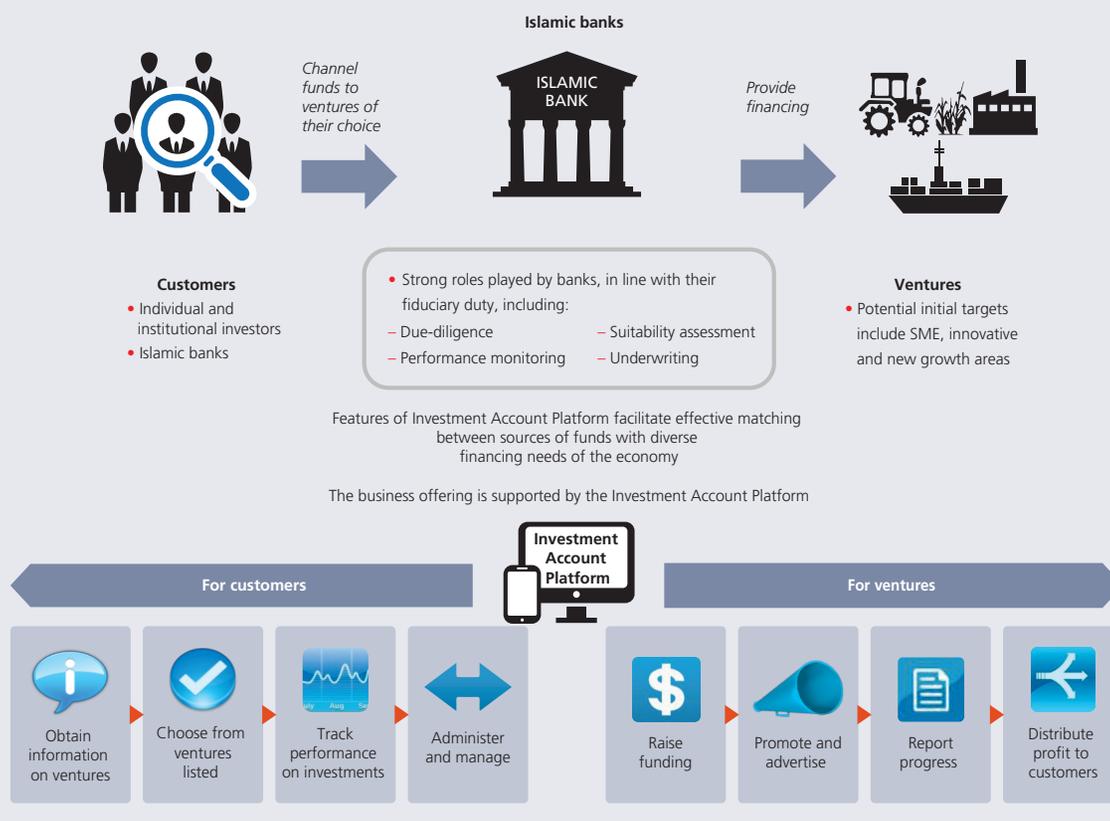
- Wide choice of viable ventures – The ventures listed on the platform will be subject to prior assessment and screening for viability by the sponsoring Islamic bank. All ventures listed will be Shariah-compliant.
- Control over the quality and coverage of important information for decision-making – Each venture listed will be accompanied by important information provided to customers which must comply with minimum disclosure standards covering the description of the venture, the terms of financing (such as the tenure and profit-sharing ratio), the estimated profit rate and the risk level of the venture as categorised by the sponsoring bank.
- Ease of transactions – Customers will be able to specify their preferences in relation to the types of ventures which they wish to invest in, based on factors such as the underlying industry, geographical location, risk level and tenure of financing. Customers can also filter investment ventures based on their selection of the sponsoring Islamic banks.

- Suitability assessment – The sponsoring bank will assess the suitability of investment in a particular venture in relation to the risk appetite and financial position of the customer. However, the decision remains with the customer on whether to proceed with the investment. Customers who choose to pursue an investment that is inconsistent with the sponsoring bank’s suitability assessment will be appropriately warned of the risks.
- Regular monitoring – Customers will be provided with a performance report on the progress of the venture at least twice a year. The report will also include an assessment by the sponsoring bank on the potential emerging risks associated with the venture.

The Investment Account Platform will be administered by an entity established by the Islamic banking players. The entity will be responsible to coordinate and manage the listing of investment ventures and sponsoring Islamic banks on the platform. Individual sponsoring Islamic banks that leverage on the platform will retain all fiduciary responsibilities to investment account holders in connection with the ventures financed through investment accounts that are offered under the platform. Diagram 3 illustrates the broad mechanics of the Investment Account Platform.

Diagram 3

Broad Mechanics of Investment Account Platform



The platform will be integrated with the existing payment infrastructure and the I.T. systems of the Islamic banks to facilitate the transfer of funds from customers at the inception of the financing and the payment of principal and any profit generated at the end of the financing period. An important distinguishing feature of the platform compared with other platforms, such as crowd-sourced funding, is the involvement of banks as a financial intermediary in the transactions.

The platform is envisaged to expand opportunities for consumers to participate on a risk-sharing basis, with greater confidence in financing entrepreneurship and other economic activities. Over a longer duration, the success of the platform could entail inclusion of multi-currency financing for ventures outside Malaysia.

The effective implementation of investment accounts, supported by the Investment Account Platform, represents another strategic initiative to propel Islamic finance in supporting real economic activity. This is achieved through the wider expansion of innovative financing structures with a central role played by Islamic banks.