The Shift of Mudharabah Products into Investment Accounts

*Market Impact and Its Acceptance*

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The Importance of building Deposits

Customers go to the Bank to enjoy the benefits of deposit accounts; either for savings purposes, transactional, returns or even salary purposes.

Banks love deposits because it is a source of cheap funds for its financing activities.

All Islamic Banks find means to boost deposits via many types of structures and Islamic contract.
1. Why do we need Deposits?

Deposit-taking is a key requirement of any business as it provides a proxy to capital and allows for business expansion via managed funds of the depositors.

**USES**
- Fund the Bank’s Asset and Financing Activities
- Deploy to Capture Investment Opportunities
- Statutory Reserves
- Replacement Liquidity
- Financial Ratios & Stability
- Fee Generator
2. Impact of IFSA on Deposits

- Islamic Financial Services Act 2013 (IFSA) introduced to replace Islamic Banking Act 1983 has put considerable pressure on deposit-taking activities by Islamic Banks.

- The biggest impact of IFSA is the definition of deposits:

  1. If a deposit, based on the Islamic contract, guarantees the principal amount to customers upon demand, it is classified as DEPOSIT.

  2. If a deposit, based on the Islamic contract, do not guarantees the principal amount to customers upon demand, it is classified as INVESTMENT.
3. IFSA Requirements

Classification of Non-Principal Guaranteed Deposits under IFSA 2013

Mudharabah Account

Wakalah Account

Re-Classified as Investments

1. Investment type of Disclosure Requirements
2. Risk Sharing infrastructure i.e. Profit Sharing / Loss Sharing
3. Principal Not Guaranteed i.e. No PIDM cover
4. Oversight function on the management of Funds required
5. Investments to be tagged to Specific Assets for performance

Issues: Specific Assets requires performance monitoring, capital allocation, portfolio management of a mature portfolio.
4. Complying to Requirements

- **Investment Account**
- **Rate of Return**
- **Liquidity Coverage Ratio**
- **Concept Paper**
- **Operational Requirements of Mudarabah**
- **Wadi‘ah**
  (Shariah Requirements and Optional Practices)
  Exposure Draft
- **HIBAH**
  (Shariah Requirements and Optional Practices)
  Exposure Draft
5. Key Summary of Regulations

**Investment Account**
- Defines “Non Principal Guarantee” as Investment
- Methodology of management of Investment Account
- Use of UA and RA
- Risk Management
- Transparency and Disclosure
- Liquidity Management
- Capital Adequacy

**Rate Of Return**
- Management of Funds
- Management of UA and RA
- Proportional Tagging
- Distribution of Profit
- Disclosure and Reporting
- Calculation Table

**Mudharabah Standards**
- Operational standards
- Utilisation of Funds
- Valuation of Investment Pool
- Management of Funds
- Distribution of Profit

**Liquidity Coverage Ratio**
- LCR Minimum Requirements (60%)
- Stock of High Quality Liquid Asset
- Expected Cash Outflows
- Expected Cash Inflows
- Investment Accounts
- Reporting Requirements
6. Meeting Requirements

- Under IFSA 2013, the reclassification of all Mudharabah-based accounts from “Deposit” classification into “Investments” must be complied with by 30 June 2015.

- Most Banks convert CASA Mudharabah to Wadiah and GIA to Commodity Murabahah Term Deposit (CMTD-i)

- Saadiq decided to launch:
  1. CMTD-i to replace GIA
  2. Investment Account to replace Mudharabah CASA

- Mudharabah and Wakalah Deposits classified as Investments
- Customer to complete the Customer Investment Profile (CIP) before signing up and Risk Rating issued
- Bank to inform the specific Asset the investment is tagged to, and the expected performance of the Asset
- Distribution of Profit is based on Actual returns, with no profit smoothing done to the returns
- New ROR Framework and Liquidity Coverage Ratio (LCR) Guidelines to comply
- Bank to provide clear terms and conditions for investment and send annual performance reports
So what is Investment Account?

How will it behave for General Investment Accounts, Current Account and Savings Account?

Information on Investment Account are available on the website of the Banks that offer the products.
THE GREAT MUDHARABAH CONVERSION EXERCISE

For the past 2 years, Islamic Banks have been scrambling to comply with IFSA 2013. Re-shuffle, Conversion, Strategy Rethink, Customer Experience.

**IA roadmap**

- **General Investment Account**
  - Forced Convert by 30 June 2014
  - Introduce IA-Term
  - Offer Term IA (GIA)
  - Do not Opt-In IA
  - Opt-In Obtained
  - Force Convert to Wadiah CASA

- **CASA**
  - Did not Introduce IA
  - Did not Opt Into IA
  - Reclassify to IA
  - Force Convert into Wadiah CASA
  - Migrate to conventional CASA
  - Uplift
  - Migrate to conventional FD

Does not include the Re-Conversion exercises
7. Industry Movements towards IA

To compete with conventional CASA, many Islamic Banks seek to develop Mudharabah CASA

Banks Converting Mudharabah CASA to Wadiah CASA
- Public Islamic Bank
- CIMB Islamic
- OCBC Al Amin Bank
- Alliance Islamic
- Bank Muamalat
- RHB Islamic
- Hong Leong Islamic Bank
- Al Rajhi Bank

Banks Migrating to Investment Account
- AmIslamic Bank
- Maybank Islamic
- Standard Chartered Saadiq
- Bank Islam
- Kuwait Finance House

Banks offering other CASA contracts (Tawarruq / Qard)

# But meeting the BNM IA requirements is a challenge for CASA products
# 8. Investment Accounts

<table>
<thead>
<tr>
<th>Product Structuring</th>
<th>• Investment Objectives / Minimum Amount of Investment / Investment Tenure / Redemption of Investment / Profit Sharing &amp; Agency Fee / Product Approval</th>
</tr>
</thead>
<tbody>
<tr>
<td>Management of Investment Account</td>
<td>• Separate Management of Investment Account / Valuation of Investment Account</td>
</tr>
<tr>
<td>Oversight Arrangements</td>
<td>• Role of the Board (Board Committee) / Shariah Committee / Senior Management</td>
</tr>
<tr>
<td>Risk Management &amp; Internal Control</td>
<td>• Policies and Procedures / Investment Concentration Risk Limit / Single Counterparty Exposure Limit / Liquidity Risk Management / Audit Function</td>
</tr>
<tr>
<td>Business &amp; Market Conduct</td>
<td>• Suitability and Fair Dealing Practices</td>
</tr>
<tr>
<td>Transparency &amp; Disclosure</td>
<td>• General Principles / Product Disclosure Sheet / Terms and Conditions of agreement / Investment Account Performance Report / Financial Reporting</td>
</tr>
</tbody>
</table>
9. Specific Instructions by BNM

Differences between RIA & URIA

**Restricted Investment Account (RIA)**
- Use of funds limited to specific restrictions/conditions set by IAH e.g. purpose, asset classes & industry.
- Underlying assets are potentially specific e.g. high-risk return & illiquid investments.
- Strict redemption conditions are imposed to effectively mitigate liquidity risk to IAH.
- Redemption only upon maturity of assets.
- Early redemption subject to replacement of funds from other IAH or disposal of asset.
- Set clear expectations on rights & responsibilities in operational issues e.g. Capital injection by current IAH if cost-overrun.

**Unrestricted Investment Account (URIA)**
- Use of funds not subject to any restrictions/conditions set by IAH - however, still bound by investment objectives disclosed to IAH.
- Underlying assets are generic (potentially common assets in IBI's such as financing & trading assets).
- IAH may be exposed to liquidity risk as:
  - IAH may allow early redemption.
  - Maturity mismatch - i.e. maturity of investment shorter than maturity of underlying asset.

Illustration:
- **Fixed-term (3 years)**
- **Project Financing (3 years)**

Separate management requirement under Revised ROR

<table>
<thead>
<tr>
<th>Dedicated funds</th>
<th>Pooled funds</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>RIA</strong></td>
<td><strong>URIA</strong></td>
</tr>
<tr>
<td>100% Project Financing</td>
<td>10% MM Instruments</td>
</tr>
<tr>
<td>40% Equity</td>
<td>20% Other Investments</td>
</tr>
<tr>
<td>50% Personal Financing &amp; Credit Card Facilities</td>
<td>70% Diversified Financing</td>
</tr>
</tbody>
</table>

Identification of investment assets

1. I Bs MUST identify assets
2. Identify percentage of funding contribution
3. Appropriately tag assets

Liquidity management of IA – by funds basis

- **RIA Fund**
  - Objectives: Mixed Fund / Risk Profile: Moderate
  - 20% Equity / 40% Sukuk / 40% Mixed Financing

- **URIA Fund 1**
  - Objectives: Income & Moderate Growth / Risk Profile: Low
  - 10% Equity / 30% Sukuk / 50% Mortgages

- **URIA Fund 2**
  - Objectives: Aggressive Growth / Risk Profile: High
  - 10% MM Instruments / 40% Equity / 50% Personal Financing & Credit Card Facilities

- **RIA Fund**
  - Objectives: Long-Term Capital Appreciation / Risk Profile: High
  - 51% Equity & Wholesale Funds / 40% Mortgage Financing / 60% Project Financing
Reclassification of CASA to IA

Saadiq introduced Investment Account (CASA-equivalent) beginning May 2015 and completed the conversion to IA in July 2015.

Total number of customers impacted: Approx 65,000

Above: Sample letter that customers get to encourage them to convert to Investment Account
10. Conversion Success (Industry)

Success by Islamic Banks has been mixed and more focus in retaining selected High Value customer segments rather than conversion for mass market accounts.

GENERAL INVESTMENTS
55% to 64% → CMTD-i
(via forced conversion on maturity or early upliftment)

CURRENT / SAVINGS ACC
7% to 21% → IA
(via opt-in conversion by 30 June, else Wadiah-based Acc)
11. Impact of Investment Account

- **Unsuitable Needs** – Customer seeking CASA, but faced with additional disclosure requirements and terminologies. A lot of effort required for awareness.

- **Deposit Flight** – CASA has been long associated with principal protection, movements to Wadiah-based and conventional banking.

- **Product Change** – Some feature changed which is yet to be accepted; potentially higher returns (but hardly seen), capital at-risk, warnings, loss of PIDM coverage.

All the above have resulted in challenges for Islamic Banks to grow deposit to fund the financing activities. With impending Qard guidelines, Islamic Banks is expected to face a liquidity crunch.
Challenges in Investment Accounts.

Investment Accounts are supposed to behave like Unit Trust or other similar investments. But will customers have confidence that Banks are as equipped as Unit Trust companies with fund managers?

The first Bank to launch Investment Account under Mudharabah contract in Malaysia
12. Key Structural Differences

### CASA Mudharabah
- Shariah Contract: Mudharabah
- Returns: Agreed Profit Sharing Ratio
- Product Benefits allowed up-front
- Principal: Not Guaranteed
- Guidelines: ROR Framework

### CASA Wadiah
- Shariah Contract: Wadiah
- PIDM COVER
- Doc : T&C
- Returns: Discretionary
- Classification: Deposit
- Principal: Guaranteed
- Product Benefits Not allowed

### Investment Account
- Classification: Investment
- Doc : T&C, PDS, Performance Report
- No DCR methods for Profit Smoothing
- Suitability Assessment Required (CIP)
- Specific Pool of Investment
- Guidelines: Liquidity Coverage Ratio

### General Pool of Investment
- Guidelines: ROR Framework
### 13. “I see Unit Trust”

<table>
<thead>
<tr>
<th></th>
<th>Deposit Acc (CASA)</th>
<th>Investment Account</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Type of Shariah Contracts</strong></td>
<td>Wadiah / Qard</td>
<td>Mudharabah Wakalah</td>
</tr>
<tr>
<td><strong>Principal</strong></td>
<td>Protected</td>
<td>Not Protected</td>
</tr>
<tr>
<td><strong>Profit</strong></td>
<td>Discretionary</td>
<td>Profit Sharing</td>
</tr>
<tr>
<td><strong>Loss</strong></td>
<td>Not Applicable</td>
<td>Lower Returns</td>
</tr>
<tr>
<td><strong>Treatment on Balance Sheet</strong></td>
<td>On-balance Sheet</td>
<td>Off-Balance Sheet or On-Balance Sheet</td>
</tr>
<tr>
<td><strong>Risk Profile</strong></td>
<td>No Risk</td>
<td>Low/Medium Risk</td>
</tr>
<tr>
<td><strong>Tenure</strong></td>
<td>On Demand</td>
<td>Minimum tenure</td>
</tr>
<tr>
<td><strong>PIDM Coverage</strong></td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td><strong>Disclosure Format</strong></td>
<td>Savings Account</td>
<td>Unit Trust</td>
</tr>
<tr>
<td><strong>Investment Instruments</strong></td>
<td>General Investment Account</td>
<td>Defined Investment Account i.e. Unrestricted Investment Account (URIA) or Restricted Investment Account (RIA)</td>
</tr>
<tr>
<td><strong>Customer Documents</strong></td>
<td>Terms and Conditions</td>
<td>PDS, Terms and Conditions, Performance Report and Risk Warning Statements</td>
</tr>
</tbody>
</table>

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**IS THE CUSTOMER READY FOR THIS NEW “INVESTMENT ACCOUNT” EXPERIENCE?**
14. “CASA” is different now

- Many Banks, many structures
- Customers are now “Investors” and have to be aware of “Risks” in a CASA-type accounts
- Understanding the Investment Assets and its behaviour
- Different Assets Different Risk profile
- CASA is no longer a CASA where its use is predominantly SAVINGS AND TRANSACTIONAL
15. Managing the pools

Under the existing Mudharabah ROR Calculation, Customer deposits go into the GENERAL pool.

Under the new ROR Framework, Customer INVESTEMENT goes into specific INVESTMENTS assets, which must be clearly disclosed to Customer (historical performance, expected returns, terms of investment).
# 16. Other Issues

| No simple CASA solution | • Mudharabah / Wakalah CASA heavily governed  
  • Explore Tawarruq CASA or remain in generic CASA deposit-types (Qard, Wadiah) |
|--------------------------|--------------------------------------------------------------------------------------------------|
| PIDM Impact              | • Removal of PIDM became key loss proposition for IA, underestimated by Islamic Banks  
  • To explore the creation of “3rd party guarantee” |
| Conventional Banking push| • Opportunity for Conventional Banking to promote products  
  • Simple, easy, safe taglines being used |
| Future Regulations       | • With impending Qard and Hibah guidelines in 2016, Islamic Banks are strained for solutions  
  • Difficulty in raising funds for financing / Investment activities |
| Awareness Building       | • Contract of Mudharabah is investment-based, but with new disclosure requirements, investors sense risk on principal (although low risk) |
| Customer Profile         | • Alternative products available for the customer profile i.e. Risk taking customers  
  • Unit Trust, Shares Market, Retail Bonds, Structured Notes / Investments |
How then do Islamic Banks build Deposit or Fund customers?

Bearing in mind that the options of building funds can also via Interbank Placement, Sukuk issuance, Pricing campaigns and capital injection.

Musyarakah and Mudharabah models are also viable funding mechanisms for customers.
17. Avenues to Fund Financing Assets

- Tawarruq
- Wadiah / Qard
- IA Mudharabah / Wakalah
- Sukuk Ijarah
- Other Funding Platforms

Islamic banks are always asked to find new sources of funds to support the business activities and fund the assets.
In the Budget 2015, the PM mentioned the intention to launch Investment Account Platform (IAP) to support the small business enterprises.

The intention is to link between the retail / corporate “investors” directly with companies seeking funding for projects / business.

The model is to be similar to crowd-funding or venture capitalist. Projects can be floated on IAP for investors to provide capital.

4 Local Banks have taken the mantel to develop the IAP (target launch in H2 2016).
19. IAP Challenges

- Redemption = Replacement of Investment with other similar profile Investors
- Difficulty in Valuation for Investment (MTM) & methodology
- Operating, Credit, Market, Ownership Risks borne by Investors
- Investment for project life, Illiquid investments
- Returns = Actual Performance, Payback Period, Dividend Pay-out cycles
- Cash Flows not retained by Bank i.e. not able to benefit core deposits.
SUMMARY

Future of deposit building under IFSA 2013

- Options under Qard and Wadiah expected to be restrictive
- Investment Account offers a way to build deposits by offering potential benefits from investments
- Market is slowly moving to IA
- Acceptance towards IA is still limited and greater awareness needs to happen
- Failure to build deposits via IA will result in further stress by Islamic Banks
- Investment Account Platform (IAP), although different from IA, will provide a financing / funding avenue for clients in obtaining capital
Thank You for Listening

Question and Answer Session on Investment Account

Visit me at http://islamicbankers.me
comments / feedback appreciated

Ariffhidayat, myself and the rest of the Islamic Banking project team during our visit to Dubai.