ADVANCING IN ISLAMIC BANKING – ISLAMIC FINANCIAL SERVICES ACT 2013

By Hizamuddin Jamalluddin
General Manager/Head, Strategic Management & Managing Director’s Office
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DEVELOPMENT PHASE

Instituting Foundation
• 1970 – 1992 (Establishment of Enabling Infrastructure)
• Islamic Banking Act 1983 – Establishment of Bank Islam Malaysia Berhad
• Merely as an alternative to conventional banking

Institutional Building, Activity Generation & Market Vibrancy
• 1993-2005 (Deepening, Creating Critical Mass & Liberalisation)
• Ensuring greater access to Islamic finance

Strategic Positioning & International Integration with Global Financial System.
• 2006 -2013
• Becoming hub of international Islamic finance

Advancing in Islamic Financing – Well Developed Marketplace
• 2013 onwards
• Islamic Financial Services Act 2013 - Robust Shariah Framework
• Marketplace for Global Linkages
## EVOLUTION OF ISLAMIC BANKING LANDSCAPE

<table>
<thead>
<tr>
<th>Period</th>
<th>Simple structure to cater for basic needs</th>
<th>Customer-driven structure/products</th>
<th>Cost effective structure to compete in the competitive marketplace</th>
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<tbody>
<tr>
<td>1991 - 2000</td>
<td>✓ Bai Dayn, Musharakah, Mudharabah ICDO ✓ Wadiah Debit Card ✓ Bai Inah Overdraft ✓ Bai Inah Commercial Credit Card ✓ Bai Inah Personal Financing ✓ Bai Inah Negotiable Instrument of Deposit (NID)</td>
<td>✓ Commodity Murabahah Profit Rate Swap ✓ Commodity Murabahah Forward Rate Agreement ✓ Ijarah Rental Swaps-I ✓ BBA Floating Rate ✓ Murabahah Floating Rate ✓ Istisna’ Floating Rate ✓ Mudharabah Capital Protected Structured Investment ✓ Bai Inah Floating Rate NID ✓ Mudharabah Savings Multiplier Deposit ✓ Tawarruq Commodity Undertaking</td>
<td></td>
</tr>
<tr>
<td>2001 - 2005</td>
<td>✓ Tawarruq Business Financing ✓ Tawarruq Personal Financing ✓ Murabahah with Novation Agreement ✓ Istisna’ convertible to Ijarah ✓ Bai and Ijarah (Sale &amp; Lease Back) ✓ Musharakah Mutanaqisah ✓ Istisna’ with Parallel Istisna’ ✓ Wakalah Deposit ✓ Waqf ✓ Tawarruq Revolving Credit-i ✓ Etc</td>
<td></td>
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</tbody>
</table>

**Note** – This listing is far from being exhaustive. Although they have been developed and/or approved, some products have yet to be rolled out at the time of drafting of this presentation.
... changing financial landscape has accelerated expansion of Islamic finance industry
Basic Shariah Principles (i.e. BBA & Murabaha)

Basic Infrastructure

Limited Tax Neutrality

“Plain Vanilla” Products

Domestic/Local Players

Variety of Shariah Principles (i.e. Ijarah, Ujrah, Istisna’ etc)

Comprehensive Infrastructure

Universal Tax Neutrality

Hybrid & Structured Products

Cross-Border /Regional/Global Players

... wide spectrum of financial products and services to cater to needs of all customers from small businesses to conglomerates, from common households to high net-worth individuals
# SUSTAINABLE GROWTH OF ISLAMIC FINANCE

**Islamic finance as national agenda**  
**Attractive tax & non-tax incentives**  
**Robust & comprehensive regulatory, legal, corporate governance & Shariah framework**  
**Wide & knowledgeable investor base**  
**Adequate pool of talents & capabilities**  
**Continuous product innovation**  
**Liberal foreign exchange rules**  

... a defined strategic plan and initiatives under the Financial Sector Master Plan
“END IN MIND”

- Robust Shariah Framework
- Advocate Responsibility
- Refinement of Business Model
- Revolutionize Islamic Finance
- Cultivate Innovation
- Reshaping the Balance Sheet
- Market Dynamic - Consumerism & Maturity
- Rightsizing of Funding Mix
- Redefining Market Boundaries
- Promote Talent Enrichment
- Advocate Responsibility

“BEGIN WITH THE END IN MIND”

Covey 1989
ISLAMIC FINANCIAL SERVICES ACT 2013 ("IFSA")

**Objectives**

- Promote financial stability and more robust/comprehensive Shariah-compliance framework
- Strengthen regulation of financial institutions and consumer protection
- Implement recommendations under FSAP

**Repealed Laws:**

1. Islamic Banking Act 1983
2. Takaful Act 1984
4. Exchange Control Act 1953

*Requirements in IBA with no corresponding provisions in IFSA will be incorporated in specifications.*

The Acts were published in the Gazette on 22 March 2013
Commencement date: 30 June 2013
<table>
<thead>
<tr>
<th>Regulatory changes - Financial sector</th>
</tr>
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<tbody>
<tr>
<td>More extensive and intrusive regulation</td>
</tr>
<tr>
<td>▶ Capital, liquidity, incentive system, governance, consumer, accounting</td>
</tr>
<tr>
<td>▶ Enhanced scope of regulation for systemic institutions</td>
</tr>
<tr>
<td>Strengthened institutional arrangements</td>
</tr>
<tr>
<td>▶ To avoid gaps and clarify accountability</td>
</tr>
<tr>
<td>▶ More formalised arrangements for coordination and cooperation</td>
</tr>
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<td>International financial architecture</td>
</tr>
<tr>
<td>▶ Reforms of international institutions to reflect enhanced role, broader representation and diversity</td>
</tr>
</tbody>
</table>

**FS Vision 2020**
Regulatory and supervisory regime to safeguard the stability of the financial system

*Source: BNM Financial Sector Blueprint 2011-2020*

*In preparation to comply with BASEL III*

*Promote Best Practices*
## OVERVIEW OF IFSA

### SALIENT FEATURES

| 1. Strengthened Shariah compliance requirements |
| 2. Regulatory framework & reflective Shariah contracts |
| 3. Definitive and transparent market entry & exit requirements |
| 4. Enhanced roles and responsibilities of key functionaries |
| 5. Enhanced business conduct requirements |
| 6. Comprehensive intervention |
| 7. Oversight over financial groups to promote safety and soundness of financial institutions |
| 8. Statutory reporting duty for external auditors. |

IFSA has 291 sections, divided into 5 Divisions and 18 Parts (Islamic Banking Act 1983 has 59 sections)
An Act to provide for the regulation and supervision of Islamic financial institutions, payment systems and other relevant entities and the oversight of the Islamic money market and Islamic foreign exchange market to promote financial stability and compliance with Shariah and for related, consequential or incidental matters.
KEY STAKEHOLDERS - WHO WILL BE IMPACTED?

- Regulators
- Board of Directors
- Shareholders (Financial Holding Company)
- Service Providers (Solicitors, etc.)
- Customers/Depositors/Investment Account Holders/etc
- Employees of Islamic Financial Institutions
- Senior Management
- Shariah Supervisory Council Members
- Managing Director's Office
"An institution shall at all times ensure that its aims and operations, business, affairs and activities are in compliance with Shariah." - section 28 (1)
Islamic banks conduct financial intermediation functions using Shariah contracts (Sec. 2(1))

<table>
<thead>
<tr>
<th>ASSETS</th>
<th>LIABILITY</th>
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</thead>
<tbody>
<tr>
<td><strong>IBA</strong></td>
<td><strong>IFSA</strong></td>
</tr>
</tbody>
</table>
| "Islamic banking business" refers to banking business whose aims & operations do not involve any element which is not approved by the religion of Islam. | Clarity in scope of provision of finance:  
- Equity/partnership financing  
- Lease based financing  
- Sale based financing  
- Fee based financing  
- Currency exchange contracts  
- Other permitted activities as approved by the BNM | Covers current, saving, investment or any deposit account | Islamic Deposits - Confined to principal guaranteed Shariah contracts. I.e.; Qard, Wadiah & Murabahah.  
*Money placed for investment under principal non guaranteed Shariah contracts such as Mudharabah & Wakalah fall within investment account. (*Principal non guaranteed Shariah contract currently deemed to be Islamic deposits. )

Further Guidance:  
(a) **Shariah Standards** - stipulate compliance with fundamental requirements of the respective Shariah contracts  
(b) **Practice Guides** - stipulate the operational requirements, i.e. legal, accounting, risk management in applying the Shariah Standards
ISLAMIC BANKING BUSINESS REFLECTIVE OF SHARIAH CONTRACTS

- Wider options for Islamic banks in terms of its business model
  - Regulatory treatment aligned with distinct features of Shariah contracts
  - Business conduct and product offerings to be aligned with distinct features of Shariah contracts

Legal recognition of distinctive features of Shariah contracts

<table>
<thead>
<tr>
<th>Liability</th>
<th>Asset</th>
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<td>Principal guaranteed Shariah contracts <strong>ISLAMIC DEPOSIT</strong> (Priority of payment accorded upon winding up)</td>
<td>Provision of finance clarity of scope based on Shariah contracts</td>
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<td>Principal non-guaranteed Shariah contracts <strong>INVESTMENT ACCOUNT</strong> (Assets ring-fenced to meet liabilities-account upon winding up)</td>
<td>Any other activities as may be specified by the Bank</td>
</tr>
</tbody>
</table>
OVERVIEW OF DEPOSIT PRODUCTS

Deposit Account
- Wadiah/Qard
- Tawarruq
- Bai Inah

Wadiah/Qard
- No returns
- Marketing on services/features i.e.: debit-card facility, access to TH account, TAP mobile banking, MEPS IBFT, etc

Tawarruq
- Similar to fixed/term deposit
- Returns are fixed upfront as part of murabaha structure
- Brokerage fees to be borne by the Bank

Principal guaranteed Shariah contracts

ISLAMIC DEPOSIT
.Priority of payment accorded upon winding up.)
OVERVIEW OF INVESTMENT ACCOUNT

**1st Leg**

- Contract under IA:
  - Wakalah
  - Mudarabah
  - Musharakah

**2nd Leg**

- Bank:
  - As Agent (Wakalah); or
  - As Entrepreneur (Mudarabah); or
  - As Business Partner (Musharakah)

- Venture:
  - Contract between Bank and business owner:
    - Equity financing (Musharakah, Mudarabah)
    - Lease-based financing (Ijarah)
    - Sale-based (Murabahah, Istisna’, Inah)
    - Fee based (Wakalah, Ujra’)
    - Guarantee (Kafalah)

**INVESTMENT ACCOUNT**

- Principal non-guaranteed Shariah contracts
- Shariah contracts
- Assets ring-fenced to meet liabilities-account upon winding up
OVERVIEW OF INVESTMENT ACCOUNTS...CONT

Investors

Contract under IA:
- Wakalah
- Mudarabah
- Musharakah

Unrestricted Investment A/C

- General mandate or allow the Bank to make ultimate investment decision without restrictions or any conditions
- Unlimited withdrawal
- Mismatch maturity
- On-balance Sheet (subject to compliance with principles of FRS10)

Restricted Investment A/C

- Specific Investment Mandate/Asset Class
- Fixed tenure
- Redemption upon maturity of assets; or redemption only upon realization of underlying assets to a third party; or redemption only upon finding replacement of funds from other IAH (other than the Bank)
- Off-balance Sheet
Liabilities

- Demand Deposits
  (Qard / Wadiah Yad Dhamanah)

- Term Deposits
  (Tawarruq)

- Investment Accounts
  (Mudharabah/Wakalah/Musharaka)

- Shareholders’ Funds

- Capital Instruments (Tier I/II Sukuk)

Assets

- Financing Assets
  (Debt-based: i.e. MPO, IMBT, Istisna’, Parallel Istisna’, Inah Equity-based: Mudharabah, Musharaka, MM)

- Treasury Assets
  (Cash, Sukuk, Money Market)

- Ijarah Assets (Operating lease)

- Investments
  (Subsidiary or Associates)

- Inventory

- Non-Financial Assets
RIGHTSIZING OF FUNDING MIX

Shareholders’ Funds

Demand Deposit - CASA

Term Deposit

Unrestricted Investment Account

Transactional Investment Account

Restricted Investment Account

Note: Only for illustration
DUTY OF ISLAMIC BANK TO ENSURE COMPLIANCE WITH SHARIAH

指导BNM：
- 发布SAC裁决；
- 发布伊斯兰标准与实践指南

伊斯兰银行
- 董事会：应考虑SAC裁决、伊斯兰标准和实践指南，以及其SSC的决定；
- SSC：负责监督和建议以确保遵守

"Where an institution becomes aware that it is carrying on its business, affair, activity in a manner which is not in compliance with Shariah....the institution shall:

- immediately notify BNM and its SSC;
- Cease from carrying such business, affair or activity;
- within 30 days of becoming aware of such non-compliance, submit to BNM a plan on rectification of the non-compliance.” - Section 28 (3)

Penalties: Imprisonment not exceeding 8 years or fine not exceeding RM25 million or both.
ENHANCED BUSINESS CONDUCT STANDARDS FOR CONSUMER PROTECTION

ENHANCED BUSINESS CONDUCT (Sec 133-138 & Sec 143 - 246)

- Compliance with standards of business conduct issued by BNM when dealing with customers
- Prohibition of unfair & deceptive business conduct (Schedule 7)
- Secrecy obligations preserved with expanded list of permitted disclosure (Schedule 11)
- Establishment of alternative dispute resolution

Reinforced the principles/tenets of Islamic Finance (i.e. fair, transparent, etc)
BNM will issue standards of business conduct relating to:

1. Transparency & disclosure requirement Information provided must be accurate, clear, timely & not misleading.
2. Fairness of terms and conditions of the financing contract.
3. Promotion of financial services and products.
4. Provision of recommendations or advice including assessment of suitability and affordability of financial services & product offered.
5. Complaints & dispute resolution mechanism
### List of Prohibited Business Conduct (Schedule 7)

1. To mislead or deceive or likely to mislead or deceive in relation to the nature, features, terms or price of any financial service or product.

2. To induce or attempt to induce a customer to do an act or omit to do an act in relation to any financial service or product by -
   - Making a statement, illustration, promise, forecast or comparison which is misleading, false or deceptive;
   - Dishonestly concealing, omitting or providing material facts in manner which is ambiguous; or
   - Recklessly making any statement, illustration, promise, forecast or comparison which is misleading, false or deceptive.

3. Exerting undue pressure, influence or using or threatening to use harassment, coercion or physical force in relation to the provision of any financial service or product to a financial consumer, or the payment for any financial service or product by a financial consumer.
4. Demanding payments from a customer in any manner for unsolicited services or products including threatening to bring legal proceedings unless the customer has communicated his acceptance of the offer for such services or products either orally or in writing.

5. Exerting undue pressure on, or coercing, a customer to acquire any service or product as a condition for acquiring another service or product.

6. Colluding with any other person to fix or control the features or terms of any financial service or product to the detriment of any customer, except for any tariff or takaful contribution rates or takaful certificate terms which have been approved by BNM.

Penalties: Imprisonment not exceeding 5 years or fine not exceeding RM10 million or both.
PROHIBITION TO DISCLOSE CONFIDENTIAL INFORMATION PRODUCED BY BNM (Sec 163)

Authorized persons, financial holding companies, directors, officers, auditors & actuaries shall not disclose to any person:

- Any rating assigned by BNM or relevant overseas supervisory authorities to an authorized person of financial holding company.

- Any stage of intervention assigned to an authorized person or financial holding company.

- Any assessment of an authorized person or financial holding company made by BNM or overseas supervisory authority as a result of an examination including report, correspondences or recommendations made to such person.

- Any enforceable undertaking accepted by BNM under section 259.

- Any order made, direction issued by BNM

- Any other information as may be specified by BNM
1. With written consent by the customer, administrator or legal representative of the customer.

2. In connection with an application for faraid certificate, grant of probate, letter of administration or distribution order.

3. In case where the customer is bankrupt, wound up or dissolved.

4. In any criminal or civil proceeding between the Bank and;
   
   (a) Its customer, his surety or guarantor relating to the customer’s transaction;
   
   (b) Two or more parties making adverse claim to money in a customer’s account where the Bank seeks relief by way of interpleader; or
   
   (c) One or more parties in respect of property in or over which some right or interest has been conferred on the Bank.

5. Compliance with a garnishee order.
6. Compliance with a court order made by a court not lower than a sessions court.

7. Compliance with an order or request made by an enforcement agency in Malaysia under any written law for the purpose of investigation or prosecution of an offence under any written law.


10. Documents of information required by the Inland Revenue Board for the purpose of facilitating exchange of information pursuant to taxation arrangements or agreements.
11. Disclosure of credit information of a customer to a credit reporting agency registered under the Credit Reporting Agencies Act 2010 (CRA) – purpose of carrying on credit reporting business as defined under the CRA.

12. Performance of supervisory functions or duties by a relevant authority outside Malaysia which exercise corresponding functions to BNM.

13. Conduct of centralized function which include audit, risk management, finance, IT or any other centralized function within the financial group.

14. Due diligence approved by the BOD in connection with:
   
   (a) Merger and acquisition.
   
   (b) Capital raising exercise
   
   (c) Sale of assets or whole or part of business.
15. Performance of functions of the Bank which is outsourced.

16. Disclosure to a consultant or adjuster engaged by the Bank.

17. The Bank has reason to suspect an offence being or may be committed under any written law.

- Info required for proper purpose & disclosure is made to authorized persons.
- Proper level of authority in Islamic banks for approval of permitted disclosure

Penalties: Imprisonment not exceeding 5 years or fine not exceeding RM10 million or both.
If:
- No longer fit and proper
- Contributes to contravention of BNM direction
- Breach of enforceable undertaking

*Senior officers:
- Person having authority for planning, directing & controlling
- Members of decision making committee
- Persons performing key functions such as risk management, compliance, internal audit

**Removal of director, CEO, *senior officer, SSC member**

**Enforceable undertakings**
- The minister/BNM may accept written undertaking:
  - From any person in relation to the matter under IFSA.
  - May be used as an alternative means to address concerns instead of pursuing with other enforcement actions.
- Effect of breach: Minister/BNM may obtain high court order to enforce & seek specific performance and/or damages
CRIMINAL, CIVIL OR ADMINISTRATIVE PENALTY FOR NON-COMPLIANCE

BNM INTERVENTION & REMEDIAL ACTION

Issue direction of compliance Sec 167-168

- Power may be exercised where BNM satisfied that Islamic bank:
  - is carrying or about to carry its business, affairs & activities in a manner which is contrary to Shariah.
  - is committing or about to commit an act that is unsafe or failed to act in a manner that is necessary to maintain safety of Islamic banks.
  - is conducting business in a manner detrimental to the interests of depositors, policy owners, participants, users, creditors or the public.
  - Has failed to manage its business in a manner that is consistent with sound risk management & good governance practices.

Civil actions & administrative Sec 245-257

- Civil action
  “Where it appears to BNM that there is a reasonable likelihood that any person will contravene or has contravened or will breach or has breached or is likely to fail to comply with or has failed to comply with....”
  BNM may seek court order to impose:
  - Monetary penalty (general & for both body corporate & individual):
  - Injunction order
  - Order to comply
  - Order to remedy breach or mitigate the effect of breach

- Administrative
  Monetary penalty (for non criminal offence)
  - Body corporate : not exceeding RM5 million
  - Individual : not exceeding RM1 million
  - Order to comply certain act
  - Order to remedy / mitigate the effect of breach
  - Reprimand - including requiring person in breach to issue public statement
**IMPORTANT SPECIFICATIONS / PRESCRIPTIONS TO BE ISSUED ON COMMENCEMENT DATE**

<table>
<thead>
<tr>
<th>MATTERS TO BE PRESCRIBED</th>
<th>MATTERS TO BE SPECIFIED</th>
</tr>
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<tbody>
<tr>
<td>1. Prescribe administrative monetary penalty for different categories of breach.</td>
<td>1. Specify business or activities that Islamic banks may carry on.</td>
</tr>
<tr>
<td>2. Order to be published in the gazette on prudential requirements which do not apply or apply with modifications to FHC.</td>
<td>2. Specify what constitutes acquisition or holding of material interest in corporation which requires approval.</td>
</tr>
<tr>
<td>3. Exemption order for international Islamic banks to exclude application of certain provisions.</td>
<td>3. Specify what constitutes material part of the business of licensed person which requires consent from Minister.</td>
</tr>
</tbody>
</table>

**EXISTING REQUIREMENTS THAT ARE NO LONGER APPLICABLE**

- Approval requirement for amendments to constituent documents
- Approval requirement for annual accounts of Islamic banks
TAKEAWAYS

- Change in Mindset
- New Competitive Landscape
- Require Game Changing Strategy
- Competent Talent Pool
- Onerous Responsibility & Accountability
- Sustainability & Stability
MALAYSIA TAKES LEAD PROTECTING SHARIAH DEPOSITS

By Elffie Chew

Aug. 26 (Bloomberg) -- Malaysia is taking the lead in the Islamic banking world by tightening the classification of deposits and offering government guarantees to protect savers.

Shariah-compliant lenders have until June to comply with the Islamic Financial Services Act 2013 giving investors the option to choose how their cash is used. The measure is aimed at increasing transparency for customers who may want to put money either in safer deposits or free it up for investment under laws that prohibit interest payments and encourage risk sharing.

“The introduction of the Islamic Financial Services Act is aimed at providing greater regulatory clarity and promoting Islamic financial stability,” Hizamuddin Jamaluddin, head of strategic planning at Kuala Lumpur-based Bank Islam Malaysia Bhd., said in e-mail interview yesterday. “The move is timely as customers are mature enough to differentiate between deposits and risk-based investments.”

The act may impact the level of deposits in the short term as it will take time for customers to familiarize themselves with the ruling, according to CIMB Islamic Bank Bhd., which has complied with the new regulation and saw growth ease to 7 percent in 2013 from 15 percent a year earlier. Islamic deposits in the nation’s $110 billion Shariah-compliant banking industry rose 5 percent in the first six months of 2014, slowing from the average 18 percent annually in the past five years.
Taking Initiative

Bank Negara Malaysia is the first monetary authority in the world to implement such a rule for Islamic banks as it seeks to enhance its status as a Shariah financing hub. The country tightened its oversight of stocks last year to better reflect Koranic principles, opening the door to more funds from the Middle East.

The new ruling is positive as it will encourage innovation, said Hizamuddin at Bank Islam, the nation’s largest lender operating under religious tenets. The bank is looking to boost deposits by improving how it caters to customers’ various needs and risk profiles, he said.

Wadiah and Qard type deposits are guaranteed under the legislation. The former is where permission for the usage of the cash has to be given by the depositor, while the latter usually applies to more wealthy individuals and is a form of loan to the bank that must be free of profit.

Deposits under the Shariah concept of Musyharakah, or a partnership with profit or loss-sharing implications, will be deemed as investment accounts and won’t be protected. The same applies to the Mudarabah and Wakalah systems. Mudarabah is a joint investing arrangement, while Wakalah is an agreement between two parties for a certain business undertaking.

Bloomberg/Aug 26, 2014
Product Choice

The new formula clearly separates the different products, which can be targeted at more sophisticated consumers, said Badlisyah Abdul Ghani, chief executive officer of CIMB Islamic Bank, a unit of CIMB Group Holdings Bhd., the country’s second-biggest lender.

“Today, there is blur on these products and people can’t distinguish,” Badlisyah said in a Aug. 22 phone interview in Kuala Lumpur. “This distinction will help enhance the current Islamic framework and make it clearer for consumers.”

Islamic deposits in the Southeast Asian nation are still growing at a healthy rate and won’t be in trouble with the implementation of the new ruling as there’s enough cash around, Badlisyah said.

Malaysia, which pioneered Islamic finance 30 years ago, is the world’s biggest sukuk market and accounts for $178 billion of the $290 billion outstanding globally, according to a June 4 report from Moody’s Investors Service.

Bloomberg/Aug 26, 2014
**Bank Revolution**

Worldwide issuance of such bonds, which pay returns on assets to comply with the interest ban, climbed 27 percent to $26.9 billion in 2014 from a year earlier, according to data compiled by Bloomberg. Sales reached $43.1 billion in 2013 and an unprecedented $46.5 billion the year before.

Maybank Islamic Bhd., a unit of Malaysia’s biggest bank, will offer Mudharabah deposits as an investment account after the June 2015 deadline for the implementation of the new rules, Zainiah Zahar, the lender’s head of corporate affairs, wrote in Aug. 21 e-mail replying to questions. Bank Islam’s Hizamuddin said the lender will also comply by that time.

“The execution of the IFSA will certainly result in a revolution in the banking landscape,” Hizamuddin said. “It’s also seen as a strong commitment by the government to uphold Malaysia’s status as an Islamic finance hub.”

*Bloomberg/Aug 26, 2014*