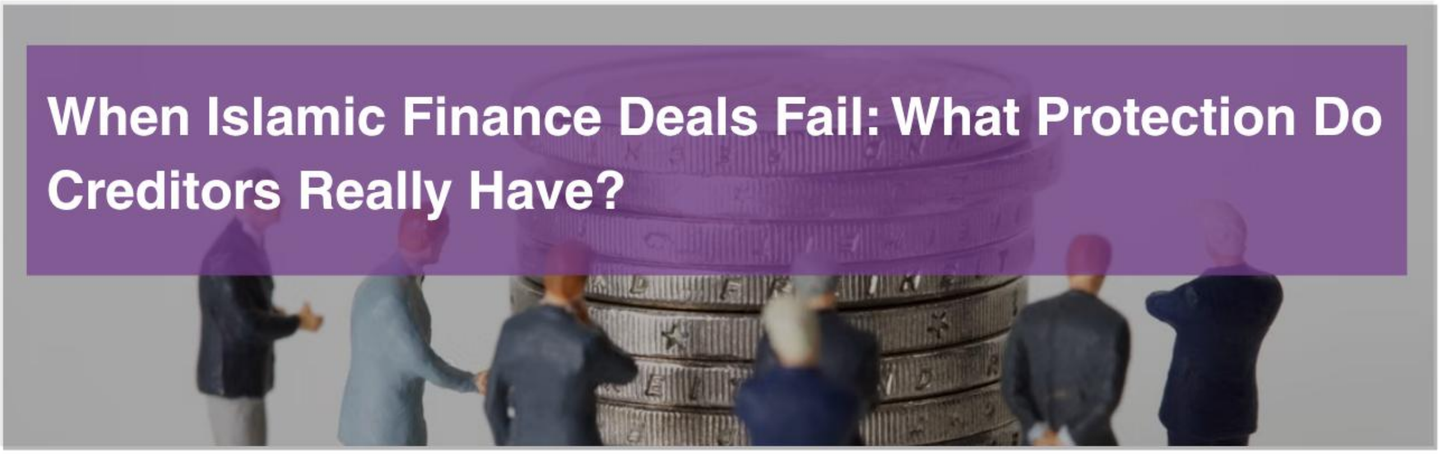
RDS
ADVOCATES & SOLICITORS

In Business Collaboration:
AMT / ANDERSON MORI & TOMOTSUNE



When Islamic Finance Deals Fail: What Protection Do Creditors Really Have?

21 August 2026

For more information, please contact:

Chia Loong Thye
ltchia@rdslawpartners.com

David Lee Lai Huat
david.lee@rdslawpartners.com

Falisa Abu Bakar
falisa@rdslawpartners.com

Hurriyyah Kamaruzzaman
hurriyyah@rdslawpartners.com

Kamilah Kasim
kamilah@rdslawpartners.com

Lim Sheh Ting
shehting@rdslawpartners.com

Michele Kythe Lim
michele@rdslawpartners.com

Ooi Bee Hong
beehong@rdslawpartners.com

Raphael Tay Choon Tien
raphael@rdslawpartners.com

Sharifah Sazita
sharifah@rdslawpartners.com

Tan Gek Im
gekim@rdslawpartners.com

Teo Siang Ly
siangly@rdslawpartners.com

Yap Wai Ming
waiming@rdslawpartners.com

For creditors and investors in Malaysia's Islamic finance market, the existence of a Shariah-compliant structure does not, by itself, answer the most important question when a transaction runs into difficulty: what can the creditor actually enforce?

The answer requires a distinction between two forms of protection.

The first is contractual and proprietary protection, created through security over assets or other credit-support arrangements. The second is statutory protection, which arises by operation of law and applies only where the creditor, depositor or investor falls within the relevant statutory regime.

The distinction is more than technical. It can determine whether a creditor has recourse to a particular asset, where it ranks on insolvency, and whether the protection claimed in the transaction documents is recognised for regulatory purposes.

Security Is Only As Good As Its Creation And Perfection

Security creation involves granting a creditor a proprietary interest in an asset to secure the performance of an obligation. Depending on the asset and transaction, this may take the form of a charge, mortgage, assignment by way of security, pledge or lien.

Islamic finance may employ Shariah-compliant arrangements such as *rahn*, alongside guarantees, assignments and trust arrangements designed to provide credit support or facilitate the holding and enforcement of assets.

The Shariah characterisation of the transaction, however, does not displace Malaysian law governing the creation, perfection, priority and enforcement of security. That distinction is critical.

A security arrangement may be entirely Shariah-compliant but still fail to provide the intended proprietary protection if the legal steps necessary to create or perfect the security have not been taken.

For companies, Section 352 of the Companies Act 2016 generally requires registrable charges created by a company to be lodged for registration with the Companies Commission of Malaysia within 30 days of its creation. Failure to register can render the security void against the liquidator and creditors, even though the underlying obligation remains.

Meanwhile, security over land raises a different set of considerations. A statutory charge under Section 243 of the National Land Code must satisfy the applicable requirements for registration before the chargee obtains the protection associated with a registered interest. Reliance on an unregistered arrangement may therefore leave the creditor in a materially different position, particularly when competing claims or insolvency intervene.

The same principle extends to securities and other financial assets. Where the applicable legal or depository framework provides a mechanism for recording or perfecting a pledge or charge, failure to comply with that framework can weaken the creditor's position against competing claimants.

The lesson is straightforward: security described in transaction documents is not necessarily security that will withstand insolvency.

Sukuk: Form Should Not Be Confused With Recourse

This distinction becomes particularly important in sukuk transactions. Sukuk are sometimes described in language suggesting that investors have an ownership interest in identified assets. But the economic and legal substance of the investor's recourse depends on the structure adopted.

In an asset-backed sukuk, investors may have meaningful recourse to assets that have been transferred and effectively separated from the originator. In an asset-based structure, by contrast, the assets may principally facilitate the Shariah structure while investors ultimately rely on contractual payment obligations and undertakings from the obligor.

Likewise, this distinction can become decisive upon insolvency. The presence of an SPV, declaration of trust or identified pool of assets should therefore not automatically be equated with insolvency-remoteness or direct enforcement rights against those assets. The transaction documents must be examined to determine what was transferred, what rights the trustee actually holds, what security has been granted and, ultimately, where sukukholders rank if the obligor defaults.

For investors, the important question is not simply whether assets appear in the structure. It is whether those assets provide an independent and legally enforceable source of recovery.

The Second Layer: Protection Created By Statute

Separate from contractual security are protections conferred by legislation and regulatory frameworks. The Islamic Financial Services Act 2013 (IFSA) provides an important part of the statutory architecture governing Islamic financial institutions, particularly Section 217, including provisions relevant to the treatment of depositors, investment account holders and creditors when an institution encounters financial difficulty or is wound up.

The distinction between a deposit and an investment account is especially significant. A depositor places money with an institution on the basis of an obligation to repay, whereas an investment account involves money accepted for investment without an express or implied obligation to repay the money in full. The allocation of investment risk is therefore fundamentally different.

This distinction also affects deposit insurance. Eligible Islamic deposits placed with member institutions are protected under the Malaysia Deposit Insurance Corporation Act 2011 and the PIDM framework, subject to the applicable statutory limits and conditions. Islamic and conventional deposits enjoy separate protection.

Investment accounts, however, should not be assumed to carry the same protection merely because they are offered by a licensed Islamic financial institution. That difference needs to be understood at the point of investment and not after the institution encounters difficulty.

Capital Market Protection Is Different Again

Sukuk investors operate within another regulatory architecture. The Capital Markets and Services Act 2007 and the Securities Commission Malaysia's applicable guidelines impose requirements concerning matters such as disclosure, trustees, transaction documentation, Shariah compliance and the rights of sukukholders. These protections are important, but they should not be confused with a statutory guarantee of repayment.

Disclosure requirements can require an issuer to explain the security arrangements and risks associated with an issuance. Trustee arrangements can provide an institutional mechanism through which investors' rights are exercised collectively. Events of default and enforcement provisions can establish what happens when the transaction fails.

None of these, however, can transform defective security into perfected security or an asset-based transaction into an asset-backed one.

Regulatory compliance and enforceability therefore remain related but distinct questions.

What Regulators Expect

The same distinction matters to regulated financial institutions. BNM's prudential framework places considerable importance on the legal effectiveness and enforceability of credit-risk mitigation arrangements. An institution cannot simply describe an asset as collateral and assume that it will receive the intended regulatory treatment.

The legal basis of the security, its enforceability and, where applicable, its perfection must be established. This has practical consequences beyond documentation. The quality of security may affect how an institution assesses its credit exposure, manages concentration and recovery risks, and determines the extent to which collateral can legitimately be relied upon as a risk mitigant.

For capital-market transactions, the SC framework similarly places emphasis on adequate disclosure of the transaction structure, security arrangements and risks borne by investors.

The regulatory objective is ultimately the same: the legal reality of the protection should correspond with the way the transaction is presented and risk-managed.

What Creditors And Investors Should Ask

For creditors and investors, four questions should be asked before relying on any supposed protection.

First, has the security actually been perfected?

Legal due diligence should establish whether all steps necessary to create, register and perfect the relevant security have been completed. Shariah compliance and legal perfection address different questions; both matter.

Second, what exactly is the product?

An Islamic deposit, investment account and sukuk may all involve the deployment of funds through Shariah-compliant arrangements, but the legal consequences are different. Product classification determines the applicable statutory and regulatory framework and may determine whether PIDM protection is available.

Third, who bears the investment risk?

This is particularly important for restricted investment accounts. The existence of regulatory and disclosure protections does not mean that the investor's capital is guaranteed. The investment mandate, risk allocation, management arrangements and contractual rights should therefore be examined carefully.

Fourth, what happens to the assets on insolvency?

For sukuk investors, this is often the most important question of all. Transaction documents should be examined to determine whether assets have genuinely been transferred and ring-fenced, whether investors have enforceable rights against them and whether competing or prior-ranking claims exist.

Protection Must Survive The Default

Creditor protection in Malaysian Islamic finance ultimately operates on two different planes. One depends upon what the parties have created through their contracts and proprietary arrangements. The other depends upon rights that Parliament and the regulatory framework confer on particular categories of persons.

The danger lies in assuming that documentation and economic description are enough. A Shariah-compliant security arrangement that has not been legally perfected may offer considerably less protection than its documentation suggests. A sukuk structure containing an SPV, trust and identified assets may nevertheless leave investors principally exposed to the creditworthiness of the obligor. An investment offered by a licensed Islamic financial institution does not necessarily enjoy the protections afforded to an insured Islamic deposit.

These distinctions tend to matter least while a transaction is performing and most when it fails. For transactional counsel, financial institutions and investors, the central question should therefore be a practical one: if the obligor becomes insolvent tomorrow, what right survives, against which asset, and with what priority? This is ultimately the test of whether creditor protection exists in substance, rather than merely on paper.

This publication is for educational and informational purposes only and is not intended and should not be construed as legal advice.

KUALA LUMPUR	PENANG	JOHOR BAHRU
Level 16, Menara 1 Dutamas No. 1, Jalan Dutamas 1, Solaris Dutamas, 50480 Kuala Lumpur T: +603 6209 5400 F: +603 6209 5411 enquiry@rdslawpartners.com	Suite S-21E & F21st Floor, Menara Northam, No. 55, Jalan Sultan Ahmad Shah, 10050 Penang T: +604 370 1122 F: +604 370 5678 generalpg@rdslawpartners.com	8-35, Menara Delima Satu, Jalan Forest City 1, Pulau Satu, 81550 Gelang Patah, Johor Bahru T: +607 585 6414 F: +607 509 7614 generaljb@rdslawpartners.com