Navigating the New Islamic Finance Landscape in Malaysia

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Abstract

Islamic banking in Malaysia has emerged as an alternative and competitor to the commonly used conventional banking system. Since its establishment, the system has been slowly adapted into the existing banking system and has proven its effectiveness and sustainability. In fact, it is reported that Islamic banking sector grew 50% faster than the overall banking sector. Islamic finance also grows with rapid pace at the value over US $2 trillion, with Islamic banking dominating at 78%, sukuk at 16%, takaful at 1%, Islamic funds at 4% and Islamic microfinance with 1%.[1] *In 2015, global Islamic banking asset with commercial banks will reach US $1.8 trillion representing 17% average annual growth. It is estimated that Islamic finance will be able to tip US $6.5 trillion by the year 2020 with the current growth rates.*[2] *This article hence aims to provide latest updates of the state of Islamic finance in Malaysia and to analyse its inherent issues and challenges.*

Introduction

Islamic banking has emerged as an alternative and competitor to the commonly used conventional banking system. Since its establishment, the system has been slowly adapted into the existing banking system and has proven its effectiveness and sustainability. In fact, it is reported that Islamic banking sector grew 50% faster than the overall banking sector. In 2011, Islamic banking assets with commercial banks grew to US $1.3 trillion and achieved at US $2 trillion by the end of 2014. Islamic finance will grow with rapid pace in the year 2015 and its volume will pass through US $2 trillion, with Islamic banking dominating at 78%, sukuk at 16%, takaful at 1%, Islamic funds at 4% and Islamic microfinance with 1%. It is estimated that Islamic finance will be able to tip US $6.5 trillion by the year 2020 with the current growth rates. The recent *World Islamic Banking Competitiveness Report 2014–2015* estimates that Islamic banking assets in Malaysia, Qatar, Indonesia, Saudi Arabia, United Arab Emirates and Turkey will reach US $1.8 trillion by 2019.

In line with the consistent growth globally, Islamic banking in Malaysia is also experiencing considerable growth and is considered as one of the fast growing and leading countries in the sector. As of to-date, Malaysia has 16 full-fledged Islamic banks, 12 Takaful operators, five international Islamic banks and six development financial institutions that offer Islamic financial services and products. With the additional players including foreign Islamic banks, the Islamic banking industry in Malaysia has shown significant progress with market share increased up to approximately 25% of the total banking system. Total Islamic financing continued to grow 16.6% and represented 26.9% of total loans in the banking system with the household sector continuing to account for the bulk of Islamic financing at 65.9%. Not only that, 799 *Shari'ah*-compliant securities were listed on Bursa Malaysia, representing 87.7% of the total listed securities, with a market capitalisation of RM 995.7 billion or 63.7% of the total market capitalisation. The Islamic Finance Development Indicator (IFDI) also classified Malaysia as the most developed and well-rounded Islamic finance market in the world.

IFSA and regulatory reform

The legal framework of Malaysia's Islamic finance system has undergone a tremendous change with the enforcement of the Islamic Financial Services Act 2013 (IFSA). The IFSA grants the Bank Negara Malaysia (BNM) with the necessary regulatory and supervisory oversight powers to fulfill its broad mandate within a more complex and interconnected environment, including introducing more comprehensive consumer protection regime and providing clear demarcation between conventional and Islamic finance.

The current regulatory framework provides a clearer and more comprehensive set of provisions for IFIs. The BNM also has wide-ranging powers to issue directives and guidelines, which are binding upon every director, officer or *Shari'ah* committee member of the institution. To complement the IFSA, the BNM has issued *Shari'ah* parameters to IFIs as guidance and reference to promote harmoniSation and standardiSation of Islamic finance

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[1] Available at: http://www.saudigazette.com.sa/index.cfm?method=home.regcon&contentid=20140102191275 [Accessed 12 December 2015].

[2] MIFC, "Expanding Islamic Finance, How Regulators are Changing the World" (2013) Kuala Lumpur.

practices. The Standards cover both Islamic banking and takaful industries. More importantly, IFSA s.28(6) provides that a failure to comply with the standards issued is an offence under the Act and carries with it a maximum penalty of eight years imprisonment or a fine of 25 million ringgit or both. In other words, this provision potentially exposes board or directors, management, officers and even *Shari'ah* committee members with heavy penalties including imprisonment. Therefore, IFIs are required to be more vigilant and diligent in carrying their business which failure may lead to potential jail terms and heavy fine to their personnel.

Post-IFSA: is there any real implication?

Law revision

As a continuing effort to overcome impediments to ensure efficiency of Islamic finance, the Law Harmonisation Committee Report formulated several recommendations to resolve issues in Islamic finance. The Committee is also studying the legal implications on the implementation of Islamic Financial Services Act 2013. Process of harmonisation here refers to the integration of the existing laws with the *Shari'ah* principles for the purpose of strengthening further legal infrastructure on Islamic finance.

With the findings from several consultations and studies, the Committee proposed several recommendations to improve the Islamic finance regulatory framework by providing legal certainty of *Shari'ah* contracts enforcement, being responsive and sensitive to implement legislative changes, developing human capital through producing highly qualified legal talent and commercially experienced judiciary and finally creating a supportive and reputable dispute resolution environment for adjudication and dispute settlement at the national and international levels.

The Committee also introduced several new legal provisions in court, such as rules on imposition of late payment charges on judgment debts, to allow better access to Islamic financing for consumers through recommended amendments to reserve land legislations at all states, to facilitate Islamic financing involving landed property through recognition of Islamic finance in the National Land Code 1965 and to amend the Companies Act 1965 in order to facilitate the effort to offer globally accepted *Shari'ah*-compliant product structures for the Islamic money market.

Investment account

With the statutory requirement to clearly separate between the deposits account and investment account, IFIs are expected to introduce a new structure of *mudharabah* investment, which reflects the actual characteristics of investment. IFSA s.2 defines investment account as an account for the purposes of investment, including for the provision of finance, on terms that there is no express or implied obligation to repay the money in full and (a) with profits-sharing, or both the profits-or-losses-sharing features; and (b) with or without any return. This provision not only classifies Islamic deposit as principal guaranteed and investment as non-principal guaranteed but also requires IFIs to facilitate proper priority of payments upon liquidation. The deposit insurance cover also will no longer be relevant for investment-type accounts.

The BNM issued Transition Policy under Islamic Financial Services Act 2013 on 14 February 2014 for the purpose of flexibility and to grant more time to enhance its operational capacity to meet the requirement. This Transition Policy allowed IFIs to continue and accepted Islamic deposits on current account, deposit account, saving account or other similar accounts under any *Shari'ah* contract including Investment deposit products until 30 June 2015. By 1 July 2015, all IFIs must have separated all of their investment deposits products either into Islamic deposits or investments accounts.

The IFSA requirement on the separation of Islamic deposit and investment account is actually to allow the banks to customise their products according to the customers' profile and risk appetite. IFIs can now offer higher returns to any investors for their investment account. To facilitate this transition period, the Malaysian Government backed the Investment Account Platform with an initial start-up fund for RM 150 million. Lembaga Tabung Haji also allocated RM 200 million for the establishment of the *Shari'ah* compliant Restricted Investment Account. By looking at the current development, Bank Islam Malaysia Berhad is the first IFI that introduced new investment account products namely *Waheed* Investment Account, Special Investment Account and *al Awfar* Account products. These investment account products are structured under the principles of *Mudharabah* and *wakalah*. It is expected that more IFIs will introduce their new investment account products this year.

Takaful business

In terms of the takaful funds, the IFSA makes it mandatory for the takaful operator to clearly segregate the takaful participants funds and the shareholders fund. The nature of *Shari'ah* contracts embedded in the takaful business model will be clearly accounted through this requirement. Another significant requirement refers to single licensed takaful business. The IFSA requires a takaful operator to separate its family business with general takaful business within a five-year grace period. Takaful operators are given five years to split their family business and general takaful business into separate entities.

The new requirements imposed on takaful operators are expected to enable the takaful sectors to operate in a solid and specialised business model that would lead to promoting takaful industry growth. Despite this positive expectation, it is observed that these requirements may create difficulties to the takaful operators if there are no proper measures to aid them. The effects include the demand for separate management, chief executive officers for both the family and general takaful companies as well as possibility for the need to establish separate different *Shari'ah* committees. We can also see the challenges faced by the takaful industry in Malaysia as a result of these statutory requirements. Takaful sector is now experiencing some difficulties particularly in retaining their existing talents including issues of staff pinching and unnatural hikes in salary and remuneration.

Shari'ah Non-compliance Report

The IFSA put strict conditions on IFIs in terms of statutory reporting. To complement the IFSA requirement, the BNM has issued *Shari'ah* non-compliance reporting guidelines. IFIs are required to immediately notify the BNM and its Shariah committee of any non-Shariah compliant activities and immediately cease from carrying on such business, affair or activity. The IFIs are required, within 30 days, to submit to the regulator a plan on the rectification of the non-compliance as provided in s.28(3)(c).

The BNM utilises an integrated system known as the Operational Risk Integrated Online Network (ORION) for guidance on treatment of *Shari'ah* non-compliant items. ORION is the BNM regulatory reporting system and processes. This system enables efficient reporting and supervision. Through this system, the BNM can easily monitor and supervise any *Shari'ah* non-compliance cases in IFIs. It is reported that since its effective date, the BNM received more than 100 submissions from IFIs for *Shari'ah* non-compliance reporting and less than 21% are actual Shari'ah non-compliance. The amount of actual loss due to this non-compliance is also significant. Generally, any money due to the *Shari'ah* non-compliance sources will be channelled to charity or returned to the rightful customers. This is the framework for the treatment of *Shari'ah* non-compliance income as part of purification processes for any IFIs in Malaysia. The nature of non-compliance factors refers to operational issues, inadequacy of documentation and internal procedure.

Shari'ah research and scholars activism

The International *Shari'ah* Research Academy for Islamic Finance (ISRA) and various Institutions of Higher Learning have been at the forefront in improving the *Shari'ah* governance related matters including research and development. The Islamic Finance Development Indicator (IFDI) acknowledges the ISRA as the top contributor of *Shari'ah* research and in 2014, the ISRA won IFN Service Providers Poll as the Best Islamic Research Firm. The overall performance of *Shari'ah* research in Malaysia is also commendable. Malaysia scored 211 points representing 31% of the total research papers on Islamic finance in the world far ahead of any jurisdictions that offer Islamic financial products and services.

The establishment of the Association of *Shari'ah* Advisors initiated by members of *Shari'ah* scholars further stimulates the degree of professionalism and talent development in Islamic finance. With 159 qualified *Shari'ah* scholars in Islamic finance in Malaysia (13% female, 13% non-Malaysian and 12% non-*Shari'ah* background scholars), Malaysia is ready to offer its *Shari'ah* talent and meet the demand of the industry. The level of awareness in the grass roots on Islamic finance is also increasing whereby *Shari'ah* scholars are now actively engaging the communities and civil society entities. To complement this, the mass media have also been very supportive by producing and publishing news, documentary, talk shows and information on Islamic finance even during prime-time hours. Besides, the BNM also makes it compulsory for all *Shari'ah* committee members to attend the *Shari'ah* Leaders Education programme, a specialised and tailored module for *Shari'ah* committee, organised by the ICLIF Leadership and Governance Centre.

Another interesting development of *Shari'ah* governance in Malaysia refers to professional indemnity Islamic insurance or takaful for *Shari'ah* committee or *Shari'ah* advisory council members. As the only legislation of its kind in the world at this point in time, the IFSA makes *Shari'ah* scholars legally accountable and liable for their duties as any *Shari'ah* committee members may be jailed for up to eight years or fined up to RM 25 million which is equivalent of approximately US $7.6 million if they fail to comply with the IFSA. This serious legal implication triggers the need of having professional indemnity Islamic insurance for *Shari'ah* scholars as in the case of advocate and solicitor or medical practitioners.

Islamic finance standards

Despite the tremendous growth and achievement, Islamic finance will face difficulties in maintaining the momentum through its existing framework and practices in the long run. While acknowledging the advantages and viability of Islamic finance, the International Monetary Fund (IMF) has reminded Islamic financial institutions (IFIs) and highlighted the need to tighten rules and comply with standards and regulations more consistently.[3] This strong message from the IMF indicates that Islamic finance must seriously consider the adoption global standards for the purpose of consistency and to ensure financial stability. Islamic finance must ensure that their operations comply with globally acceptable standards to remain competitive and efficient.

The AAOIFI has issued 88 standards and guidelines, including 26 accounting standards, five auditing standards, seven governance standards, 48 *Shari'ah*

[3] Bernardo Vizcaino,"IMF endorses Islamic finance, warns it must be implemented better" 7 April 2015 at *http://www.reuters.com/article/2015/04/07/islam-financing-imf-idUSL6N0X402120150407* [Accessed 12 December 2015].

standards and two codes of ethics. In addition, the IFSB has issued 24 standards, Guiding Principles and Technical Note for the Islamic financial services industry in the aspects of capital adequacy requirements, risk management, governance, disclosure and supervisory review processes. The issuance of these standards is crucial for the purpose of uniformity and consistency. In this respect, these standards are really necessary to promote universally acceptable practice of Islamic finance.

While acknowledging the difficulties and constraints to comply with the respective Islamic finance standards, undeniably, those standards produce great benefits and advantages. The need to implement certain standards in Islamic finance can be justified from different perspectives.

From the regulator's perspective, the standards will provide a coherent framework to be used to regulate, supervise and control the IFIs. The standards are expected to limit the variety of available Islamic finance practices, to eliminate undesirable alternatives and to promote a more efficient and stable financial system. In the context of IFIs, the standards are quite significant to mitigate necessary risk in Islamic finance, particularly the *Shari'ah* Non-compliance Risk. The standards are also relevant and necessary for the purpose of harmonisation and convergence of *Shari'ah* principles set by the international standard-setting bodies.

With reference to IFIs including the shareholders and investment account holders' perspective, the standards are indispensable for the fulfilment of their expectations and the maintenance of confidence in the overall financial service system. For instance, the standards that focus on corporate governance require IFIs to be held liable and owe highest fiduciary standards for the safety of all key stakeholders. The standards also promote transparency in Islamic finance through universal disclosure requirements. The depositors and customers of IFIs expect that the practices of universally acceptable standards for Islamic finance will result in competitive price and return. The implementation of standards will be able to avoid unnecessary cost through standardisation of these products and services.

With the current development and potential growth of Islamic finance in the future, if IFIs want to compete with mainstream global financial industry, they have no option except to improve their practices through the adoption and implementation of necessary standards. The standards will improve transparency and foster credibility of IFIs as well as to harmonise Islamic finance practices by mitigating the variety of *Shari'ah* interpretation between regions and institutions. These measures are very important in broadening the appeal of Islamic finance across jurisdiction.

Challenges ahead

Despite positive development on the Islamic finance landscape in Malaysia, there are some valid concerns over its implementation and practices. Vigorous and numerous *Shari'ah* compliance requirements will increase the cost of business and ultimately affect the level of efficiency. Since precautions and due diligence have to be exercised to prevent the offences, any measures to mitigate this legal risk will cost additional expenses. A heavy regulated business environment may negate innovation and influence the market behaviour and the players will opt for products with fewer constrains.

Another legitimate concern to the recent Islamic finance practices in Malaysia is the trend of Islamic deposit account. All contracts under *wakalah* and *Mudharabah* are deemed as investment account products and hence require additional treatment such as documentation, operation and system. Contrary to the ideal aspiration of promoting true nature of investment as stipulated under the IFSA, most IFIs are now migrating the existing *mudharabah* deposit into Islamic deposit account rather than converting into *mudharabah* investment account. The majority of *mudharabah* term deposit accounts in the market are converted into deposit accounts based on the *Shari'ah* concept of *tawarruq*. As a result, Islamic finance practices in Malaysia tend to concentrate on debt-based deposit account products and consistently neglect the investment account products both from asset and liabilities sides. In fact, the economic role of *tawarruq* does not offer any real difference with the conventional deposit.

With the rapid and speedy technological globalisation, digital banking poses another great challenge to Islamic finance in Malaysia. Since the new generation of young customers who are digitally sophisticated, Islamic finance players in Malaysia must be ready to evolve towards technology-based banking. In order to remain competitive, IFIs must not only be able to offer service-driven and value-propositions products and services but also to tender efficient digital banking systems that comply with the *Shari'ah* principles in order to meet the customers' expectation.

Conclusion

Malaysia as one the Islamic finance leaders in the world has proactively and consistently facilitated the implementation of Islamic finance through integrated, comprehensive means and initiatives. These formulae seem to be working well as we can clearly witness considerable development in terms of growth in market share, banking assets including the increase of domestic and global players. Not only that, Malaysia is also leading the global Islamic finance community in various aspects and these include *Shari'ah* research, quantitative development, governance and regulatory framework. However, there are some valid and legitimate concerns on current practices and trends of Islamic finance in

Malaysia. Only time will tell the true potential of Islamic finance in Malaysia and whether it can significantly contribute to stimulating human capital initiatives, to generating more opportunities, and to achieve its target of 40% of the country's total banking sector assets by 2020. But also, more importantly, can it link Islamic finance with the real economic development?