

Concept Paper

Fintech In Malaysia: An Appraisal to the Need of Shariah-Compliant Regulation

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ABSTRACT

The implementation of financial technology (Fintech) in the Islamic finance industry has created a totally new phenomenon of banking and financial behaviour for the stakeholders, particularly in Malaysia. As part of the financial revolution, the Islamic finance sector ought to embrace Fintech to diversify the services/products offered as the digitalisation process is taking place in the Fourth Industrial Revolution era. In order to safeguard the assimilation of the technology into the existing traditional practice of Islamic finance, Shariah-compliant regulation is, therefore, necessary for governing the potential risks associated throughout the process of financial activities. Hence, this paper intends to analyse the need for Shariah-compliant regulation to govern Fintech-related activity in the Islamic finance industry. The article emphasises the need from several aspects such as the non-comprehensiveness of the Islamic Financial Services Act (IFSA) 2013; the increasing rate of financial inclusion and; the qualifications of the Shariah Advisory Council's (SAC) members in Malaysia. It also provides recommendations through the introduction of subsidiary legislation pursuant

to IFSA; production of regulatory sandbox framework especially for Islamic Fintech firms; and emphasis on the importance of SAC members possessing knowledge in technological aspect in order to ensure the need for Shariah-compliant regulation in the Islamic finance industry is properly satisfied.

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INTRODUCTION

Financial technology (Fintech) only acts as an enabler in modern financial activities, thus it is permissible in nature so long the Shariah guidelines to avoid the prohibited elements such as *riba* (usury), *maysir* (gambling), and *gharar* (uncertainty) are observed. It only becomes impermissible if there is clear evidence that the basic rules of the Shariah are violated. For example, the existing bitcoin, being a cryptocurrency, does not satisfy valid characteristics of currency in Islam according to the majority of Muslim scholars all over the world. Hence, the use of 'bitcoin' is highly impermissible for the time being to preserve public interest (Al-Bakri, 2018).

To boost the growth of the Islamic finance industry, Fintech starts to take place in the financial sector. In Malaysia, the steady growth of Shariah-compliant Fintech start-ups, which have achieved a lot in a short space of time, opens up more opportunities for the Islamic finance sector to capitalise on (Bain, 2016). Consumers especially the millennials and technoliterate would no longer physically go to the traditional banks to conduct their financial transactions, rather they carry it out online via mobile because it is easier and faster (Rahim et al., 2019).

In 2019, the Securities Commission (SC) introduced subsidiary legislation namely the Capital Market and Services (Prescription of Securities) (Digital Currency and Digital Token) Order 2019 to regulate cryptocurrencies and all initial coin offerings (ICOs) in Malaysia. By virtue of

the law, cryptocurrencies and digital tokens are classified as securities. Cryptocurrencies are without a doubt considered the most controversial example of Fintech in Islam. As a result, this situation justifies the need to clarify the legal, regulatory, and Shariah issues relevant to such Fintech applications (Oseni & Ali, 2019). Besides that, the introduction of the Digital Management Framework in 2017 to set out the licensing and conduct requirements for the robo-advisory service in the finance industry. However, the conditions do not seek to ensure Shariah-compliance by the firms when providing the robo-advisory service. Fintech could also be applied to aspects of Shariah verification of transactions and Shariah robo-advisors. These unique features which might not be necessary for the conventional space of Fintech, necessitate the need to specifically address Fintech from an Islamic finance perspective. Alas, until this moment, no Shariah-compliant regulation is introduced to govern the Islamic Fintech industry.

This article undertakes a localised approach in practising Islamic Fintech, especially in Malaysia. As people would question the need for Shariah-compliant regulation in Fintech practice, this article intends to analyse further on that issue. The reason is to accommodate the legal changes required by the Islamic finance market, whether in the course of the significance of Fintech, Shariah-compliant regulation to govern Fintech activities is needed or not. Drawing from the prior statement, the next part of this article explains the needs of Shariah-compliant regulatory due to several

aspects such as the non-comprehensiveness of the Islamic Financial Services Act (IFSA) 2013; the increasing rate of financial inclusion and; the qualifications of the Shariah Advisory Council (SAC) members in Malaysia. Then, recommendations are provided to justify the need for Shariah-compliant regulations in Islamic finance and how it could be properly met in Malaysia.

ISLAMIC FINANCIAL SERVICES ACT 2013 (IFSA) IS ONLY FOR TRADITIONAL PRACTICE OF ISLAMIC FINANCE

At present, the Islamic Financial Services Act (IFSA) 2013 acts as one of the important branches of the Shariah governance framework developed by the Central Bank of Malaysia (BNM). Malaysia seeks to enhance the Shariah governance and Shariah compliance effort of the Islamic financial services sector by legislating such Act. It underlines a complete Shariah compliance commitment of the Islamic finance industry across various dimensions namely the Shariah governance framework; Shariah standards for each contract used in Islamic financial transactions; pre-emptive measures to address issues of concern within Islamic Financial Institutions (IFIs) that may affect the interests of depositors and policyholders; and the effective and efficient functioning of Islamic financial transaction. Simply saying that the primary objective of the Act is to ensure all operations, undertakings, businesses, affairs, and activities conducted by the IFIs are in adherence with the principles of Islamic law at all times (Laldin & Furqani, 2018). The strict compliance of

the IFIs with Shariah principles prescribed for such distinct contracts would secure the sanctity, righteousness, and legitimacy of Islamic financial transactions.

The rationale of the Islamic Financial Services Act 2013 (IFSA) is to substantially reinforce the foundation of a potent and transparent supervisory and regulatory framework to create a financial system that is competitive and susceptible to future challenges. But the surge of popularity towards Fintech and Islamic Fintech is a rapid and unexpected phenomenon to emerge. There is no doubt that the existing law is certainly extensive enough to encompass broad areas of the traditional banking and finance industry. However, current Shariah governance does not cover the recent modern financial activities which deal with technology such as cryptocurrency, blockchain, big data, crowdfunding, artificial intelligence, insurtech, and robo-advisory in the Islamic finance sector. Even though most IFIs actively engage with Fintech providers to diversify the features of their products and services in the Fourth Industrial Revolution (4th IR) era, no specific regulation has been enacted to ensure the conformity of Shariah principles in this field.

The reality that it was enacted through a fusion and evaluation of previous legislation concerning financial institutions supported the assertion that the current laws are deliberately designed for traditional institutions. For example, IFSA 2013 governs payment systems but consideration should be given to the fact that digital payment systems are subtly different from

their classical counterparts (Hui et al., 2019). For example, a smart contract is gradually gaining momentum in the Islamic finance market as the contracting parties no longer need a trusted third entity when performing a transaction. Instead, the transaction is self-executed once the pre-defined conditions are met and it is controlled completely by computers. However, it is noteworthy to highlight that the transaction is processed by the blockchain. This is the point where the intervention of Shariah regulation is needed to ensure the performance of the technology in such transaction does not contradict the basic rules of *muamalat* jurisprudence in Islam. Unfortunately, IFSA 2013 does not specifically cater to the governance of Fintech in Islamic finance. As much as the traditional Islamic finance industry needs IFSA 2013 to govern the business activities, likewise the Islamic Fintech market.

Generally speaking, there are a lot of studies suggesting that banking performance – including bank financing – is coherently influenced by banking regulations (see, for instance, Barth et al., 2001; Naceur & Omran, 2011). This is relatively obvious knowing that a stable banking and financial system will stimulate long-term economic growth by allocating funds to more productive investments in comparison with a poorly functioning financial system (Nastiti, 2019). In particular, regulations have been an integral enabler in driving open banking. Clearly articulated regulations promote an environment conducive to the sustainability of the Islamic finance ecosystem and provide guidance on best practices (Capgemini, 2019).

The status quo requires the policymaker in Malaysia to continue assessing the appropriateness and adequacy of the regulatory framework governing Islamic finance matters. This is due to the fact that the implementation of Fintech has increased exponentially in this field from the past, with the goal of gaining benefits from the advantage and reducing the risks simultaneously. Thus, this situation actually demands not only the production of advanced technology-based deterrents and pro-active detection systems but truly efficient cooperation between the key players in the industry such as the regulators, Islamic banks and financial institutions as well as the Fintech providers is also needed to achieve the goal.

INCREASING RATE OF FINANCIAL INCLUSION

Financial inclusion appears to be a path channelling to the development goals which can reduce the percentage of global poverty and increase the standard of living worldwide (Baber, 2019). Islamic finance tackles the issue of financial inclusion from two angles; firstly, by promoting risk-sharing arrangements that offer a viable alternative to traditional debt-based funding, and second, by particular instruments of social wealth redistribution. Consequently, should the policymakers in Muslim countries be earnest to improve accessibility to finance or 'financial inclusion' in their country, they should leverage the maximum potential of Islamic instruments to attain this objective (Mohieldin et al., 2012).

According to the World Bank, 1.7 billion adults remain unbanked in 2017 (World Bank, 2018) while the unbanked adult population in Malaysia is recorded at 8% which represents 1.82 million adults from the total of 22.8 million adult populations nationally (Bank Negara Malaysia [BNM], 2019; Department of Statistics of Malaysia [DOSM], 2019). The religious obligation was established as one of the main factors of voluntary financial exclusion, especially for Muslims. Based on a survey conducted by the World Bank, 6% (102 million) of a total 1.7 billion unbanked adults mentioned religious concerns as a reason to not sign up for a banking account (World Bank, 2018). Furthermore, 12% of adults in the Middle East and North Africa (MENA) have stated religious consideration as the sole reason for not having an account in a formal financial institution such as the conventional bank to avoid themselves from any usurious (*riba*) and uncertain (*gharar*) financial activities.

Islamic Fintech is somehow lagged behind and losing potential clients coming from the huge population of Muslim consumers. This is due to the strong attachment to Islamic values which has made it absolutely stringent to gain wealth through Fintech innovation. This is because Muslims always believe that assets are supposed to be acquired only by labour and risk. (Todorof, 2018) However, the presence of Shariah-compliant regulation may alter the typical perception. In fact, the large portion of the unbanked Muslim population can be taped by widening Islamic financial offerings (Malaysia International Islamic Financial Centre [MIFC], 2014) via

the implementation of the Islamic Fintech system. With smartphone penetration being in the Muslim-majority countries, the demand for practical and digital Islamic finance solutions are emerging (DinarStandard, 2018).

Looking at the Southeast Asian (SEA) region, out of 600 million people, only 27% of the region's population own a bank account, and approximately 40% of the unbanked are occupied by the Muslims. The Shariah-compliant regulation should act as a driving force in contending with financial inclusion for Islamic Fintech. The increased accessibility of Shariah-compliant crowdfunding and peer-to-peer (P2P) financing platforms creates opportunities for individuals and Small Medium Enterprises (SMEs) who need funding or financing but are not yet qualified to obtain it from the traditional IFIs. For instance, in the case of Singapore-based Islamic Fintech company KapitalBoost, it provides short-term financing alternatives with a quick and friendly approval process at competitive rates for the SMEs, which are often at a disadvantage in accessing business expansion funds. The contract of financing is provided through Shariah-compliant structures namely *Wakalah*, *Murabaha*, and *Qard* (Hasan, 2017).

Malaysia is a Muslim-majority nation with enormous potential for more platforms to emerge that satisfy its strict desire to adhere to the values of the Islamic religion (Pikri, 2019). The Central Bank of Malaysia (BNM) reported that internet banking and mobile banking subscribers had a penetration rate of 91.9% and 33%

respectively in February 2019 (KPMG, 2019). It clearly reflects the participation in internet banking and finance activities has risen in Malaysia, a Muslim-majority nation. In 2018, over half of internet users use internet banking (54.2%) compared to 41.7% in 2016 (Malaysian Communication and Multimedia Commission [MCMC], 2018). Although cash is still the preferred payment mode for Malaysia, the increase of usage in electronic payment shows a positive upward demographic. Based on the transaction value data recorded by the BNM in 2018, internet banking transactions were valued at RM7.6 trillion; internet banking at RM100.1 billion, and e-money at RM11 billion (KPMG, 2019).

This definitely shows that more consumers in Malaysia are being receptive to the practice of internet banking which is part of Fintech as their daily banking and the percentage has increased from time to time. This suggested that substantial strides were taken to address the financial exclusion particularly among Muslims in Malaysia. With proper governance of Shariah-compliant Fintech via regulatory approach, more Muslims, even the non-Muslims would have trust and confidence in the Islamic Fintech market. Hence, this situation would increase the rate of financial inclusion, especially in Malaysia, a Muslim-majority nation.

QUALIFICATIONS OF THE MEMBERS OF SHARIAH ADVISORY COUNCIL (SAC)

Section 53 of the Central Bank of Malaysia Act (CBMA) 2009 provides that in any

event of appointing the members of Shariah Advisory Council (SAC), the members must be a person who has the qualification, knowledge, or experience in several fields namely Shariah, law, finance, banking or such other related disciplines. Meaning that any person cannot be appointed as a member of SAC unless he/she is well-equipped with the requirement under this section. It also clearly expresses the importance of possessing such qualifications as those traits are crucial in ascertaining Islamic law pertinent to the products or services offered by the IFIs.

As Fintech is all about the technology used in the financial system, it is essential especially for the members of SAC to equip themselves with the knowledge in this area. However, the CBMA does not give much importance to the said requirement when appointing the members of SAC. If one argues that knowledge or experience in technology may be included under the term '*other related discipline*' in the section, a question arose as to why is there a need to specifically mention the fields of Shariah, banking, finance, and law, should the term '*other related discipline*' may also cover the aforementioned disciplines of knowledge. The expertise and knowledge in the technology aspect must be expressly stated just like how the other fields are mentioned to show the necessity of having this trait as a member of SAC.

When the Central Bank of Malaysia Act 2009 was enacted, the implementation of technology in finance is not as rapid as in the meantime. With the rapid development

of Fintech's technology and innovation, financial institution personnel may not be equipped with the necessary skills to prevent and detect fraud in Fintech (Bokanyi, 2016). That is why we need those who have expertise in technology to facilitate the SAC in ascertaining matters related to Islamic Fintech.

RECOMMENDATIONS

Shariah compliance is paramount when it comes to Fintech solutions in Islamic finance, and this should be subjected to the same principles applicable to commercial activities. Based on the discussion so far, the authors would like to provide some recommendations to satisfy the needs aforementioned.

First and foremost, new payment systems such as digital or online payments may be regulated through subsidiary legislation issued pursuant to IFSA 2013. In the United Arab Emirates (UAE), the financial regulators have officially introduced the initiatives to allow Fintech companies to participate and test their solutions in environments with lighter-touch regulation. Following the introduction of its Fintech legislative framework, the Financial Services Regulatory Authority (FSRA) of Abu Dhabi Global Market (ADGM) opened its regulatory laboratory known as Regulatory Laboratory (RegLab). Likewise, the Dubai International Financial Centre (DIFC), the Dubai Financial Services Authority (DFSA) unveiled its Innovation Testing Licence (ITL) in 2017 that serves as a regulatory sandbox (Rizvi et al., 2019).

This will, however, require legal adaptation (*takyif fiqhi*) to address the peculiarities of Fintech, as there are no precedents to these disruptive innovations. This has been proposed recently by the Dubai Financial Services Authority (DFSA) which seeks to subject Shariah-compliant equity crowdfunding platforms to the original rules applicable to Islamic financial institutions. While in Bahrain, the governance of Fintech regulations is vested under the exclusive control and sole responsibility of the Central Bank of Bahrain (CBB). The nation has undertaken a number of regulatory initiatives since May 2017 to increase the importance of Fintech there. In the past two years, they introduced the regulatory sandbox and proceeded in the same year with the introduction of crowdfunding regulations and the launching of the Fintech and Innovation Unit (Fintechnews Middle East, 2019).

With regard to Islamic Fintech, the Shariah Advisory Council (SAC) could become the cornerstone to grow the industry of Islamic finance. The SAC should be given a more active role to promote the application of Fintech solutions in this field (Hui et al., 2019). Even though the involvement of SAC sometimes would incite controversy in the Islamic finance market, Section 51 of the Central Bank Act of Malaysia (CBMA) 2009 positioned the Council as the apex body in ascertaining Islamic finance matters. The law itself affirmed the highest status of the Council when it requires any reference made to the SAC pertinent to Islamic finance matters must be followed and its decision prevails in any event.

It is undeniable that the governing authority such as the BNM, every now and then provided guideline to the banking and financial sector with a view to strengthen and improve the security measures taken by all participating institutions. For example, the BNM had issued BNM/GP11 which provides the consumer protection guidelines on electronic fund transfers. This guideline describes the basic framework for assessing consumer and financial institutions' rights, liabilities, and their obligations directly related to Electronic Fund Transfer (EFT) (Miskam et al., 2018).

However, the mere guideline is insufficient to bind every IFIs. If it is not a binding regulation, the IFIs would feel less compelled to follow the guidelines. For instance, if the Fintech firms do not comply with the guidelines, their license would be confiscated. However, the authors feel that this mechanism is reactive in character. The aim of the regulation is supposed to prevent the occurrence of this event as the issue of Shariah non-compliance is seriously associated with religious belief. The non-compliance would not only result in confiscating the firms' license, but it would likely ruin the good reputation of the Islamic finance industry as a whole, thus losing the customer's confidence in the Shariah governance system. As known, law, and regulation should be the best mechanism to observe the compliance of Shariah principles by the industrial players throughout the financial activities from the beginning until the end. Therefore, this

situation reflects the need for the regulators to come up with Islamic Fintech regulations in Malaysia.

Secondly, the Central Bank of Bahrain (CBM) explicitly listed financial inclusion as the principal key objective in its sandbox (Jenik & Lauer, 2017). For this purpose, the Bank came up with crowdfunding, crypto-asset, open banking regulations to provide a wider range of financial inclusion in the country. Whereas in the UAE, the Regulatory Framework for Stored Values and Electronic Payment Systems 2017 set out the requirements imposed upon the micropayment payment service provider. The requirements must be fulfilled by the payment service providers who offer micropayment solutions facilitating digital payments targeting the unbanked and underbanked segments in the UAE (Murray & Sanni, 2017).

In order to protect the integrity of the Islamic finance industry, the Islamic Fintech companies/providers cannot simply claim to be Shariah-compliant without being licensed and accredited as such by the authorities. As a starting point, it is suggested for the BNM to work collaboratively with SAC in producing a regulatory sandbox framework, especially for Islamic Fintech firms. Just like how such Sandbox has been established for the conventional Fintech firms, it is time to shift the focus on the Islamic Fintech providers. A regulatory sandbox may enable the regulators to revise and shape the regulatory and supervisory framework with agility. The authorities such as the BNM and

SAC could come up with specific guiding principles on Shariah compliance and advise the participants of the proposed Sandbox. Thus, through this Sandbox, the regulators could ensure that the participants comply with Shariah principles when offering their products and services in the Islamic finance industry.

Thirdly, the SAC members play a big part in the ecosystem of the Islamic finance industry. If the members are not well-equipped with the knowledge and expertise in technology, this situation might cause hurdles and difficulties in the implementation of Fintech in the sector. The current status quo of the provision may delay the process of regulating Islamic Fintech through laws and legislations. Therefore, amending section 53 of the Central Bank of Malaysia Act 2009 by specifically requiring the knowledge and expertise in 'technology' would strengthen the workforce of SAC. However, it is noteworthy to highlight that this amendment is suggested to expedite the process of understanding the underlying principle of the technology used together with the financial activity. Although BNM and other financial institutions have competent IT personnel who could always assist the SAC with any technology-related questions that they may have, the final decision would be made by the SAC members. If the members do not have any background or knowledge about technology, they would possibly be unable to appreciate the potential of Fintech as an enhancer in traditional Islamic finance transactions.

CONCLUSION

Malaysia is a leading nation in Islamic finance, yet more effort is required to lead Fintech development worldwide. Some interesting trends have developed, notably the acceptance of consumers on the implementation of financial technology in the financial business. It is praiseworthy that Malaysia is very committed to maintain our leadership in Islamic finance globally. Thus, this article has highlighted the reasons that the Islamic finance market is in need of Shariah-compliant regulation to govern modern financial activities. The existing regulations seem to be insufficient to cater to Fintech-related activities in the Islamic finance market. It is strongly recommended that the regulators consider the launching of Shariah-compliant regulation to govern any Islamic financial activities which adopt Fintech. If not, this issue would be left unregulated and caused financial and economic loss to the nation. Looking at the status quo of this Muslim-majority nation on the positive reception of Fintech in Islamic finance, this is the right moment to come up with the said regulations.

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