chapter five

islamic banking and takaful

Background

The Islamic banking and takaful industry has made steady progress since the establishment of the first Islamic bank in 1983 and the formation of the first Islamic insurance company (takaful) in 1984.

As at end-2000, the Islamic financial sector was represented by two Islamic banks, 47 conventional banking institutions (17 domestic commercial banks, four foreign-owned banks, 14 finance companies, five merchant banks and seven discount houses) participating in the Islamic Banking Scheme (IBS), an Islamic money market, two takaful companies and a broad range of financial products. Upon completion of the merger exercise among the domestic banking institutions, the number of conventional banking institutions participating in the IBS will be 33, comprising of nine domestic commercial banks, four foreign-owned banks, eight finance companies, five merchant banks and seven discount houses.

The significance of Islamic banking has been on a progressive upward trend, recording an average annual growth of 49% in terms of assets over the period 1995-1999. During the year 2000, the Islamic banking sector continued to register a strong asset growth of 30% to RM47.1 billion whilst deposits and financing increased to RM35.9 billion and RM20.9 billion, respectively. In terms of performance relative to the banking system, as at end-2000, the share of Islamic banking assets increased to 6.9%, whilst deposits and financing increased to 7.4% and 5.3%, respectively. The delivery channels have also improved significantly as there are more than 2,200 branches of Islamic banks and IBS banks offering Islamic banking products and services. Islamic banking has also spurred efforts by other non-bank financial intermediaries such as the development financial institutions, savings institutions and housing credit institutions to introduce Islamic schemes and instruments to meet their customer demands. In addition, the capital market has seen the rapid growth of Islamic debt securities and equity markets. To complement these developments, the Labuan IOFC has also embarked on a serious effort to establish an International Islamic Financial Market to stimulate the creation of liquidity and financial instruments as well as enhance investment opportunities aimed at greater mobilisation of Islamic funds.

`On takaful activities, the takaful fund assets of both family and general takaful have registered an average annual growth of 68% for the period 1986-2000. Over the same period, total takaful contribution recorded an average annual growth of 47%. On the family takaful business, the total participation in force increased from RM16.7 million in 1986 to RM25.6 billion in 2000.

Although the performance of the Islamic banking and takaful industry has been encouraging, it is still relatively insignificant compared with conventional banking and insurance. The current market penetration level of Islamic banking of 6.9% in terms of assets implies a significant potential still remains untapped. On takaful business, the level of market penetration in terms of takaful certificates over the total population is only 2% compared with a market penetration of 28.4% for conventional insurance business. It is therefore timely to formulate specific strategies to develop further Islamic banking and takaful. Moving forward, these strategies will also contribute to strengthening Malaysia as a regional Islamic financial centre.

The ability of the Islamic banking and takaful industry to capture a more significant market share in a rapidly evolving and challenging financial environment is dependent on the strategic positioning of the domestic industry players to maintain the competitive edge and become market leaders. Specifically, the Islamic banking and takaful industry is expected to face the following challenges:

- Increased competition as a result of globalisation and financial liberalisation. The emergence of global conventional players in Islamic banking business is clearly evident particularly in the area of structuring Syariah-compliant investment and financing deals;
- Increasing role of technology in shaping the microstructure of business and financial markets, contributing to enhanced efficiency and competitiveness; and
- New generation of well informed consumers demanding differentiated and sophisticated products.

Against this backdrop, in order for the Islamic banking institutions (comprising of Islamic banks and IBS banks) and takaful operators to become leaders in the industry, compete effectively and at the same time preserve their niche, there is a need to:

- Strengthen their institutional and operational capacities and build their resilience to operate successfully in a highly competitive globalised environment;
- Improve their efficiency and effectiveness to be at par with international best players; and
- Intensify research and development efforts in Islamic financial product innovation. This will involve Islamic banking institutions (IBIs) and takaful operators to consider the possibility of forging strategic alliances to tap the research and development expertise developed outside the banking and insurance industry to create the range of Islamic financial products capable of meeting the customer requirements.

Vision and Objectives

The overall objective is to create an efficient, progressive and comprehensive Islamic financial system that contributes significantly to the effectiveness and efficiency of the Malaysian financial sector while meeting the economic needs of the nation. The specific recommendations are formulated with a view of building the capabilities of IBIs and takaful operators to compete effectively and to increase the significance of their market share in the financial system. In addition, the underpinning financial infrastructure needs to be strengthened to support the expansion of Islamic banking and takaful operations envisaged.

It is envisioned that the Islamic banking and takaful industry landscape in 2010 would evolve in parallel with conventional banking and insurance to achieve the following:

- Constitute 20% of the banking and insurance market share with an effective contribution to the financial sector of the Malaysian economy;
- Represented by a number of strong and highly capitalised IBIs and takaful operators offering a comprehensive and complete range of Islamic financial products and services;
- Underpinned by a comprehensive and conducive Syariah and regulatory framework;
- Supported by a dedicated institution (Syariah commercial court) in the judiciary system that addresses legal issues related to Islamic banking and takaful;
- Supported by a sufficient number of well-trained, high calibre individuals and management teams with the required expertise; and
- Epitomise Malaysia as a regional Islamic financial centre.

Recommendations

The set of recommendations presented seeks to build the necessary foundations in terms of capacity building, the provision of infrastructure and regulatory framework development, to achieve the vision and objectives outlined above. The efforts by BNM need to be complemented by that of the IBIs and takaful operators to bring about the crystallization of an efficient, progressive and comprehensive Islamic banking and takaful industry. The recommendations are therefore designed to focus on three main areas:

- **Institutional capacity enhancement**
  Strategic steps will be taken to prepare the Islamic banking and takaful industry players to be among the best managed institutions, capable of capitalising on the unique features of Islamic banking and takaful to achieve significant competitive edge. The recommendations involve measures to ensure that the scarcity of skilled manpower in Islamic banking and takaful are adequately addressed. In addition, the development of management teams and the continuous application of benchmarking to elevate the performance level will be given due focus.

- **Financial infrastructure development**
  Specific measures will be taken to promote a healthy competitive culture among the Islamic banking and takaful players and create sufficient market depth to build distinct competitive advantage in a dynamic financial environment. Among the initiatives in this direction entail the issuance of new Islamic banking and takaful licenses as well as the stimulation of Islamic financial engineering in product development and risk management. The emergence of the International Islamic Financial Market in Labuan is expected to play a complementary role in spurring the development of the domestic Islamic financial market by facilitating cross border access to global markets, players and expertise.

- **Regulatory framework development**
  Concerted efforts will be directed to create a separate and viable platform for Islamic banking and takaful to function effectively in parallel with conventional banking and insurance. The legal, regulatory and Syariah framework of Islamic banking and takaful will be strengthened further through the review of the existing laws and guidelines governing the industry. Code of ethics will be one of the core determinants in disciplining the industry with less emphasis on central bank's intervention.

I. Institutional Capacity Enhancement

Recommendation 5.1:

Introduce a benchmarking programme

Benchmarking is essential for IBIs to be at par with international best practices. Hence, a benchmarking programme will be introduced to facilitate IBIs in evaluating their relative efficiency, identifying the performance gaps and formulating strategies to improve and deliver the best results.

Recommendation 5.2:

Enhance knowledge and expertise

To increase the pool of bankers and takaful operators who are knowledgeable and competent, efforts will be directed to promote human capital development to support the envisaged growth of the industry via:

- Establishing an industry-owned institution on Islamic banking and finance dedicated to train and supply a sufficient pool of Islamic bankers and takaful operators as required by the industry; and

- Requiring IBIs and takaful operators to commit adequate budget allocation for skills development to enhance knowledge and expertise in the field of Islamic banking and takaful.

Complementary measures will also be taken to create and increase awareness amongst the public on the concept and advantages of Islamic banking and takaful as well as customer education on misperceptions. This will be achieved by:

- Encourage IBIs and takaful operators to embark on regular promotional programmes on Islamic banking and takaful. IBIs and takaful operators will be encouraged to form strategic alliance with institutions of higher learning to enhance knowledge on Islamic banking and takaful; and

- Enhance the teaching of Islamic banking and takaful in school curriculum and in institutions of higher learning.

Recommendation 5.3:

Build strong management teams

To build capable and innovative management teams committed to Islamic banking and takaful, the employment of experienced and qualified staff, including expatriates to facilitate transfer of knowledge and expertise will be encouraged. The recruitment of expatriates will complement the efforts made to build the skills of the domestic industry players.

Recommendation 5.4:

Grant incentives to structure Islamic private debt securities (PDS)

As part of the effort to nurture major domestic players as well as market makers in the Islamic capital market, IBIs will be given incentives to originate and arrange Islamic PDS.

II. Financial Infrastructure Development

Recommendation 5.5:

Increase the number of Islamic banks to stimulate competition

In order to capitalise on competition as the driving force for growth, the number of full-fledged Islamic banks will be increased over the medium term. As an interim measure, efforts will be directed to develop potential eligible players by reviewing the Islamic Banking Division (IBD) structures and formulating policies to strengthen these IBD models. This will also provide the basis to identify potential players that have achieved the critical mass with the adequate infrastructure and that are ready to operate as full-fledged Islamic banks.

To stimulate greater competition and to accelerate greater international integration, consideration will be given to issue Islamic banking licenses to qualified foreign Islamic banking players that have presence in the global Islamic banking industry.

Recommendation 5.6:

Increase the number of takaful operators

New takaful operators will be licensed to achieve the following:

- To accelerate the expansion of takaful business in parallel with the relatively advanced Islamic banking;
- To inject greater market competition in terms of pricing, product innovation, customer service and operational efficiency;
- To facilitate retakaful among takaful operators in line with Syariah principles;
- To promote ASEAN Retakaful International (L) Ltd.

as the leading retakaful operator in the region; and

- To promote Malaysia as a centre for takaful expertise.

Recommendation 5.7:

Deepen the Islamic financial market

To further promote Malaysia as an Islamic financial centre, a deep market structure will be developed to fulfil the diverse and sophisticated requirements of customers whilst safeguarding the soundness and integrity of the financial system as a whole. In this respect, measures will be directed to:

- Intensify research and development efforts in the field of Islamic banking and finance. These initiatives will be undertaken independently by the IBIs as well as on a collective basis via the industry-owned research and training institute;
- Devise a comprehensive approach to risk management and appropriate mechanisms to mitigate risks. This is due to the different contractual relationship in Islamic financial transactions between IBIs and their customers thus giving rise to distinct risk attributes. It is also important for the asset and liability committee in IBIs to focus on building a financially sound portfolio to sustain the competitive edge of IBIs in a dual banking environment; and
- Encourage the application of mudharabah and musyarakah financing via the setting up of a special fund or subsidiary to undertake these modes of financing. IBIs need to carry out studies to identify the potential areas in which these modes of financing will be most feasible.

III. Regulatory Framework Development

Recommendation 5.8:

Strengthen the regulatory framework for Islamic banking

The impetus for future growth has to emanate from a separate regulatory platform in order for the industry to break away from its infancy stage and focus on its own set of banking principles. As such, emphasis will be given towards:

- Strengthening the Islamic Banking Act (IBA) 1983 taking into account the distinct characteristics of Islamic banking while not compromising the regulatory and prudential aspects. The revised IBA will create a conducive environment for Islamic banks to move towards a supervised market approach and framework;
- Fine-tune the BAFIA to accommodate the unique characteristics of Islamic banking. IBS banks will be further regulated to ensure that the risk management profile of the banking institutions with regard to Islamic banking operations are adequately addressed and monitored;
- Developing a regulatory framework for Islamic banking by introducing a separate capital adequacy, statutory reserve and liquidity requirement both for Islamic banks and IBS banks; and
- Harmonising the Syariah opinions on Islamic banking and finance to enhance efficiency and promote market development.

Recommendation 5.9:

Improve the regulatory framework for takaful

A comprehensive regulatory and supervisory framework will be developed to support the sound expansion of the takaful industry. Among the main areas covered are as follows:

- Review the Takaful Act 1984 and subsidiary legislations to address the existing inadequacies of the acts;
- Progressively increase the statutory minimum paid-up capital of takaful operators to equip them with sufficient capital base to strengthen their capacity to grow and absorb greater risks. An enhanced capital base for takaful operators will also improve their ability to compete effectively in the domestic market and subsequently, at the international level;
- Introduce accounting standards for takaful business and draft Model Accounts for takaful operators; and
- Monitor and refine further the code of ethics and standard market practices for takaful operators.

Recommendation 5.10:

Establish an effective legal structure

One of the pre-conditions to sustain the continuous growth of Islamic banking and takaful is a comprehensive legal infrastructure to seek any legal redress arising from Islamic financial transactions. A sufficient number of competent lawyers and judges equipped with sound knowledge and expertise in both Syariah and civil laws is needed to handle legal matters on Islamic financial contracts to promote confidence amongst the industry practitioners and customers. In this regard, steps will be taken to:

- Form a committee to establish a Syariah commercial court dedicated to deal with legal matters on Islamic banking and takaful. In the interim, an Islamic banking tribunal will be formed to serve as a foundation for the ultimate establishment of the proposed court; and
- Design dedicated awareness and training programmes for judges and lawyers on Islamic banking and takaful, to be conducted by the industry-owned research and training institute in consultation with the Judiciary and Bar Council.

Recommendation 5.11:

Create a favourable tax regime

Formulation and amendments to tax policies to take into consideration the impact on Islamic banking and takaful to avoid creating barriers in adopting Islamic banking concepts and takaful products.

Approach to Implementation

The implementation of the master plan for Islamic banking and takaful will be undertaken under three phases:

PHASE I

Strengthening the operational and institutional infrastructure

Under this phase, the focus of implementation will be to prepare a viable platform for the sound expansion of Islamic banking and takaful. This involves improving the prevailing operational structure of IBIs, establishing the industry-owned

research and training institute, formulating an effective Syariah and regulatory framework, preparing a preliminary legal structure as well as creating market depth. Efforts to enhance the capabilities of IBIs and takaful operators will also begin under this phase to prepare them for increased competition under Phase II. In addition, the first phase will entail the identification of potential IBS banks (domestic) and insurance companies deemed eligible to be accorded new Islamic banking license and takaful license under the second phase.

PHASE II

Stimulating competition and upgrading the infrastructure

Under the second phase, new licenses will be issued to qualified domestic industry players to stimulate increased competition. The focus under the second phase will be to enhance performance as well as to upgrade the infrastructure of the Islamic banking and takaful industry.

PHASE III

Raising performance standards through progressive liberalisation and ensuring an effective infrastructure

Phase III will involve the issuance of Islamic banking license to qualified foreign Islamic banking players which would drive improved performance, leading to enhanced efficiency and financial innovation in the industry. In addition, measures will be directed to ensure the development of a comprehensive and effective infrastructure to support the financial operations of IBIs and takaful operators in a more liberalised environment.